PROCEEDINGS

OF THE

THIRTY-FIRST ANNUAL CONFERENCE ON

TAXATION

UNDER THE AUSPICES OF THE

National Tax Association

HELD AT DETROIT, MICHIGAN
OCTOBER 24-28, 1938

AND

MINUTES OF THE ANNUAL MEETING OF THE MEMBERS
OF THE NATIONAL TAX ASSOCIATION
HELD OCTOBER 27, 1938

EDITED BY

W. G. QUERY
Secretary

COLUMBIA, S. C.
NATIONAL TAX ASSOCIATION
1939

NATIONAL TAX ASSOCIATION

OFFICERS

1938–1939

President

A. H. STONE

Chairman, Mississippi Tax Commission

Vice-President

CHAS. W. GERSTENBERG

Prentice-Hall, Inc.

Secretary

W. G. QUERY

Chairman, South Carolina Tax Commission

Treasurer

ROBERT J. EBY

Assistant Secretary, American Telephone and Telegraph Compa

Executive Committee

The above Officers and

PAST PRESIDENTS

PHILIP ZOERCHER, Indianapolis, Ind.

OSCAR LESER, Baltimore, Md.

SIMEON E. LELAND, Chicago, Ill.

ELECTIVE MEMBERS

Term Expiring 1939

J. R. SEAMAN
Chairman, Colorado Tax Commission

J. B. JONES
Attorney-at-Law, Montgomery, Ala.

Term Expiring 1940

J. H. THAYER MARTIN
State Tax Commissioner of New Jersey

RAYMOND D. THOMAS
Oklahoma A. and M. College, Stillwater, Okla.

CHARLES D. ROSA
Former Member, Wisconsin Tax Commission, Madison, Wis.

Term Expiring 1941

RAYMOND H. BERRY
Attorney-at-Law, Detroit, Mich.

NORMAN MacDONALD
Mass. Federation of Taxpayers Associations

ROGER J. TRAYNOR
University of California, Berkeley, Calif.

HONORARY MEMBERS

L. I. McMAHON
Bell Telephone Co. of Canada, Montreal

A. K. EATON
Department of Finance of Canada, Ottawa

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CERTIFICATE OF INCORPORATION OF NATIONAL TAX ASSOCIATION

No. 20264

This is to certify that we the undersigned, all being persons of full age and citizens of the United States and the majority being citizens of the District of Columbia, desiring to associate ourselves for scientific and educational purposes and to that end, to form a body politic and corporate, under the provisions of sub-chapter three of Chapter Eighteen of the Code of Law for the District of Columbia, approved March 3, 1901, and Acts of Congress amendatory thereto, do hereby make, sign and acknowledge this certificate in writing, stating as follows:

First: The name or title by which the association or corporation shall be known in law is NATIONAL TAX ASSOCIATION.

Second: The term for which the corporation is organized is perpetual.

Third: The particular business and objects of the corporation are as follows:

To educate and benefit its members and all others who may be interested in the subject of taxation and the subject of public finance, of which taxation forms a part, by promoting the scientific study thereof generally, by the encouragement of research, by collecting, preserving, and diffusing scientific information and knowledge relating thereto, by organizing conferences and bringing together for discussion public officials, taxpayers and their representatives, students, instructors in universities and colleges and others interested in the subjects of taxation and public finance, by publishing and distributing reports of conference proceedings and such other books, periodicals and publications as may be desirable and helpful for the accomplishment of the purposes of the corporation; by appointing committees for the investigation of problems in taxation and public finance; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed economic thought and ripest administrative experience available for the guidance of public opinion, legislation, and administration, on questions relating to taxation and public finance; by acquiring, utilizing, applying, and disposing of property and funds exclusively in establishing, maintaining, improving, and extending the benefits and usefulness of the corporation, through the accomplishment of its

purposes, and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

The promotion of the above declared business and objects shall at all times be carried on subject to the following conditions and limitations, by which the corporation and all who shall hereafter associate themselves with it, as members, as participants in its deliberations and activities and in its conferences or otherwise, shall be forever bound; that is to say:

The activities of the corporation shall be non-political and non-sectarian.

No part of the net income of the corporation shall at any time inure to the benefit of any officer or member of the corporation or of any individual or corporation whatsoever.

At any conference which the corporation may organize, members of the corporation shall not be entitled to vote, by reason of such membership, on any matter involving the official expression of the opinion of the conference on a question of taxation or public finance of general public interest, but the voting on such questions shall be vested in such persons in attendance as may be determined by the corporation and be expressed in such manner as may be prescribed by the conference when assembled.

At any such conference, the persons attending shall, by such attendance, be deemed to consent to the condition and limitation that the result of a vote upon a matter involving the official expression of the opinion of the conference on a question of taxation or public finance of general public interest shall not be announced or be given publicity in any report thereof issued by the corporation or be taken as having its endorsement, unless there shall have been full discussion thereof, at that or a prior conference and unless the vote shall represent the substantially unanimous opinion of the conference, which shall be deemed to be expressed by not less than a four-fifths vote.

Fourth: The number of the managers of the corporation, who shall be called the executive committee, shall for the first year of its existence, be sixteen.

Witness our hands this 6th day of January, A. D. 1930.

(S) Thomas Walker Page
(S) John E. Walker
(S) William P. Richards
(S) Robert J. Eby
(S) Alfred E. Holcomb

District of Columbia, ss:

I, Walter F. Studdiford, a Notary Public in and for the District of Columbia, do hereby certify that Thomas Walker Page, John E. Walker, William P. Richards, Robert J. Eby and Alfred E. Holcomb, parties to the annexed and foregoing certificate of incorporation, bearing date the 6th day of January, 1930, personally appeared before me in said District the said Thomas Walker Page, John E. Walker, William P. Richards, Robert J. Eby and Alfred E. Holcomb, being personally well known to me to be the persons who executed the said certificate of incorporation and severally acknowledged the same to be their act and deed.

Given under my hand and notarial seal this 6th day of January, A. D. 1930.

(S) Walter F. Studdiford,
(Notarial Seal) *Notary Public, D. C.*

Office of the Recorder of Deeds
District of Columbia

This is to Certify that the foregoing is a true and verified copy of the Certificate of Incorporation of the *National Tax Association* and of the whole of said Certificate of Incorporation, as filed in this Office this 6th day of January, A. D. 1930.

In Testimony Whereof, I have hereunto set my hand and affixed the seal of this Office this 6th day of January, A. D. 1930.

Arthur G. Froe,
(Seal) *Recorder of Deeds, D. C.*

Paragraph Four of Clause Third of the Certificate of Incorporation of the National Tax Association as amended by Certificate of Amendment filed in the office of the Recorder of Deeds of the District of Columbia August 11, 1938:

No part of the net income of the corporation shall at any time inure to the benefit of any officer or member of the corporation or of any individual or corporation whatsoever. In the event of the dissolution of the corporation or the discontinuance of its activities, its property and assets shall be donated to one or more such organizations or institutions as in the judgment of the executive committee or other managing body then in office will best use such property in the promotion of the aims and purposes expressed in this certificate.

BY-LAWS OF THE NATIONAL TAX ASSOCIATION

(As adopted Jan. 6, 1930 and amended Oct. 1, 1936 and Oct. 28, 1937)

ARTICLE I

Membership

Section 1. Any person shall be eligible to membership and may become a member, upon application in writing and payment of annual does for the current year. Such application shall indicate sympathy with the objects and purposes of the association, as expressed in its certificate of incorporation and willingness to be bound by the conditions and limitations contained therein and in these by-laws, *Provided* that the present members of the National Tax Association, an unincorporated association, shall be members, without further action on their part.

Section 2. Membership shall be continuing. The annual membership dues shall be five dollars, payable upon application for membership, covering the fiscal year of the association then current and annually thereafter, in advance, on the first day of the subsequent fiscal year.

In the discretion of the executive committee, the annual dues may at any time be increased and the annual dues of residents of any foreign country may be fixed at an amount in excess of those of residents of the United States.

Any member who shall fail to pay his dues within six months from the date when payable shall be considered in arrears and if such failure shall continue for a period of one year, he shall be dropped from membership, for non-payment of dues.

ARTICLE II

Annual Conference

Section 1. An annual conference on taxation shall be held under the auspices of the association, at such time and place as the executive committee may determine. The annual conference shall be the means used by the association for carrying into practical effect its purpose to secure an expression of opinion that will formulate and announce the best informed economic thought and ripest administrative experience available for the correct guidance of public opinion and legislative and administrative action on all questions pertaining to taxation, and to interstate comity in taxation.

Section 2. The personnel of each annual conference shall be composed of delegates appointed by the governor of other chief executive of states, public officials having duties with respect to the investigation, enactment and administration of tax laws, instructors

and students in universities and colleges, taxpayers and their representatives, and others interested in the subjects of taxation and public finance.

SECTION 3. The voting power of the conference upon an official expression of its opinion is limited, with the purpose of safeguarding the conference from the possibility of having its expression of opinion influenced by any class interest, or consideration for those who devote their time to the work or management of the association, or favor for those who contribute money to its support.

The voting power in each conference upon any question involving an expression of the opinion of the conference on a question of taxation or public finance of general public interest shall be vested in the delegates in attendance appointed by the governor or other chief executive of states. In voting upon such questions each state shall have one vote, and in case of a division of opinion among the delegates therefrom, the vote shall be divided, so as to give proportional weight, by approximate fractions, to the opinions of the respective delegates.

If the result of such vote shall not reflect substantial unanimity on the subject in question, no publication thereof shall be made and it shall not be considered as expressive of the opinion of the conference. Such unanimity shall be deemed expressed by a four-fifths vote.

Voting by proxy shall not be allowed.

No member of this association shall have the right to vote in any annual conference solely by virtue of such membership.

SECTION 4. One session of each annual conference, or so much of it as may be necessary, shall be devoted to the consideration of the report of the conference committee on resolutions and conclusions. The report of this committee, as adopted by the conference, shall be its official expression of opinion, and it shall not be held to have endorsed any other expression of opinion, by whomsoever made.

No resolution approving or opposing legislation shall be considered by the conference unless it has been discussed at a session of the conference at which it is proposed, or has been the subject of a report made thereon by some committee of the conference or of the corporation, or has been the subject of a resolution adopted by some previous conference.

SECTION 5. The temporary and permanent chairman, secretary, official stenographer, address of welcome and response to the same, meeting place, accommodations for delegates, all necessary preliminary details for each conference, and the program of papers and discussions, shall be arranged for the conference by the executive committee of the association. All other details of the organization and conduct of the conference shall be arranged by the delegates present in such manner as they may from time to time decide.

ARTICLE III

Annual and Special Meetings of the Association

Section 1. The annual meeting of the association shall be held in connection with the annual conference, at such time as the executive committee may determine. Sixty days' notice shall be given to all members of the time and place at which such annual meeting is to be held, by publication in the official Bulletin of the association or by mailing such notice to each member.

Section 2. Special meetings of the association may be held at any time and place, when called by the executive committee. At least thirty days' notice shall be given to all members of each special meeting, by publication thereof in the official Bulletin of the association or by mailing such notice to each member, which notice shall specify the purpose for which the meeting is called, and no business shall be transacted at such meeting, other than that specified in the notice.

Section 3. A majority of all members present at any annual or special meeting of the association shall constitute a quorum for the transaction of business, but such quorum shall at no time be less than fifteen, and whenever the attendance of members exceeds one hundred, twenty-five shall constitute a quorum.

ARTICLE IV

Officers and Executive Committee

Section 1. The affairs of the association shall be administered by a president, a vice-president, a secretary, a treasurer and an executive committee, consisting of the above officers and the three ex-presidents who have last held office, who shall be members *ex-officio*, and nine elected members. The necessary number of the three last ex-Presidents of the National Tax Association, an unincorporated association, shall be members *ex-officio*, so long as necessary to make the number in that class three. The officers shall be elected annually by the members and, with the exception of the president, shall be eligible to re-election. Their terms of office shall begin thirty days after the date of the meeting at which they are elected and they shall hold office until the terms of office of their successors begin.

The elected members of the executive committee shall be divided into three classes, of equal number, each class holding office for three years and until their successors have been elected, provided that at the first election held after the adoption of these by-laws, three classes shall be established, of three members each, to hold office for terms expiring at the time of the first annual meeting of the corporation for the election of officers and of the next two succeed-

ing annual meetings respectively, and thereafter three members shall be elected at each annual election, for a term of three years, and also such additional members, if any, as may be necessary to fill vacancies, to hold office during the remainder of the terms of the members whose places they fill. No member shall be eligible for re-election to the committee to succeed himself, but this provision shall not be applicable to *ex-officio* membership therein.

Two persons residing in the Dominion of Canada may be elected annually to serve as honorary members of the executive committee.

A vacancy in any office or in the membership of the executive committee may be filled by the executive committee for the unexpired term.

The executive committee may appoint such other officers and agents as it may deem appropriate to the purposes of the association, to serve during the pleasure of the committee.

ARTICLE V

Duties of Officers and Committees

Section 1. The executive committee shall manage the affairs of the association, subject to the provisions of the certificate of incorporation and of these by-laws. All appropriations of the funds of the association must be authorized or approved by the executive committee. Meetings of the executive committee shall be held at such times as the committee may determine. At such meetings a majority of the committee shall constitute a quorum. By order of the president, propositions may be submitted to the members of the executive committee, to be voted upon by mail ballot, with the same force and effect as if voted upon in meetings of the committee.

The executive committee shall have power to appoint standing or special committees and prescribe their duties.

The executive committee shall have full power and authority, in the interval between meetings of the association, to do all acts and perform all functions which the association itself might do or perform, except that it shall not have power to amend the certificate of incorporation or the by-laws.

The executive committee may authorize the president, or in his absence or inability to act, the vice-president, the secretary and the treasurer to exercise all the powers and functions of the committee, with respect to matters and things arising in the routine management of the association, requiring the formal action of the officers, during the intervals between the meetings of the committee.

Section 2. The president shall be the chief executive officer of the association and shall preside at the meetings of the association and of the executive committee, and shall perform such other duties as the executive committee shall prescribe.

In case of the absence or inability of the president, the duties of the office shall be performed by the vice-president, and in his absence, by such member of the executive committee as that committee may designate for the purpose.

SECTION 3. The secretary shall keep a record of the proceedings of all meetings of the association and of all other matters of which a record shall be ordered by the association.

He shall issue notices of all meetings of the association and shall perform such other duties as may from time to time be assigned him by the association or the executive committee.

SECTION 4. The treasurer shall keep a complete roll of the members. He shall have the care and custody of all funds and property of the association and shall deposit the funds of the association in such banks and depositories as the executive committee shall designate. He shall, under the direction of the executive committee, disburse all moneys and sign all checks and orders for the payment of money. He shall, when authorized by the executive committee, execute the papers necessary for the transfer of any property or securities of the association. He shall perform all the acts incident to the position of treasurer and may, in the discretion of the executive committee, be required to give an appropriate bond, at the expense of the association.

His accounts shall be audited by a committee of the association or otherwise, as the association may prescribe, and he shall at the annual meeting make report of the financial transactions of the association for the past year.

ARTICLE VI

PROCEEDINGS AND PUBLICATIONS

SECTION 1. The association shall provide for the publication and distribution of the proceedings of the annual conference.

SECTION 2. The executive committee shall authorize the terms of sale or of distribution of all publications issued by the association.

ARTICLE VII

CONSTRUCTION

The word "state" whenever used in these by-laws shall be deemed to comprise state, territory, the District of Columbia, an insular or other possession of the United States or a place over which the United States exercises extra-territorial jurisdiction, and a Canadian province.

ARTICLE VIII

Amendments

Section 1. These by-laws may be amended at any annual or special meeting of the association by a two-thirds vote of all members present; provided, the full text of the proposed amendment shall have been submitted to the members, either by publication in the Bulletin of the association or by mailing the same to each member at least thirty days prior to the meeting.

FIRST SESSION

MONDAY, OCTOBER 24, 1938, 10:00 A. M.

PRESIDENT SIMEON E. LELAND, presiding.

PRESIDENT LELAND: The record will show that we have started promptly at ten o'clock, and I think we will need all the time at our disposal that we can secure.

By virtue of the authority vested in me as president of the National Tax Association, I declare The Thirty-first Annual Conference, held under the auspices of the National Tax Association for the consideration of important tax problems, open and ready for business.

The by-laws of the association provide that this is a conference held under the auspices of, rather than a meeting of, the National Tax Association itself.

The meeting of the National Tax Association, an annual affair, will be held on Thursday night in the midst of the conference held under the auspices of the association. So that there will be no confusion between the two events, I hasten at the very beginning to make that point clear.

The program, as you have already discovered, is rather lengthy, but it is served up in Swedish style so that from this smorgasbord you can take what you like and leave those items which do not appeal to your taste. If you can stand it, we hope you will stay the entire time and attend all the sessions.

It is important, therefore, considering the length of the program, that we begin on time, that we observe the rules as punctiliously as the etiquette of the session permits, and that we carry on our discussions without any lengthy to-do.

The rules of procedure in general provide for the reading of papers some twenty minutes in length, and provide that discussion from the floor shall not exceed seven minutes, and that no one person shall be recognized a second time until the floor has been granted to everyone else who desires to speak.

In the taking care of the mechanics of the conference, it is desirable that you should, if you care to participate in the discussion, rise and state your name and the state from whence you came—clearly and in a sufficiently loud voice so that our reporter here can hear and get an accurate record of your name, your state, and then your remarks.

I will now ask Mr. Query, secretary of the National Tax Association, who, under the by-laws, becomes the secretary of this conference, to read the rules which have previously been employed in the conduct of these meetings.

Mr. Query!

SECRETARY W. G. QUERY: "General. The provisions of the Certificate of Incorporation and By-Laws of the National Tax Association shall govern the conduct of this conference generally, and these rules of procedure shall be considered supplemental to, and subject to interpretation by such provisions.

"*Discussion.* The usual rules of parliamentary procedure shall control. Each speaker shall be limited to twenty minutes, for the presentation of a formal paper. He shall be warned two minutes before the expiration of such period. The time of such speaker may be extended by unanimous consent of those present.

"In general discussion, each speaker shall be limited to seven minutes, and such time shall not be extended.

"No person shall speak more than once during the same period of discussion until others desiring to speak have been given an opportunity to do so.

"*Voting Power.* The voting power in this conference upon any question involving an expression of the opinion of the conference upon a question of taxation or public finance, of general public interest, shall be vested in the delegates in attendance, appointed by the governor or other chief executive of the state.

"In voting upon such questions, each state shall have one vote, and in case of a division among the delegates therefrom, their votes shall be divided, so as to give proportional weight, by approximate fractions, to the opinions of the respective delegates.

"If the result of such a vote shall not reflect substantial unanimity on the subject in question, no publication thereof shall be made, and it shall not be considered expressive of the opinion of the conference. Such unanimity shall be deemed expressed by a four-fifths vote.

"Voting by proxy shall not be allowed.

"On all questions, other than those involving an official expression of the opinion of the conference, the voting shall be by all in attendance.

"*Committees.* The receipt of reports made to this conference by committees of the National Tax Association shall not be considered as expressing the opinion of the conference on the subject stated.

"The following committees shall be appointed:

"(a) A committee of three on credentials, to be appointed by the chairman, who shall designate the chairman of such committee.

"(b) A committee on resolutions, composed of one person from each state, to be appointed by the chairman of the conference, who shall also designate the chairman of such committee.

"*Resolutions.* All resolutions involving an expression of opinion of the conference shall be read to the conference before submission to the committee, and shall be immediately referred, without debate.

"*Definitions.* The word 'state' as used in these rules shall comprise state, territory, the District of Columbia, an insular or other possession of the United States, or a place over which the United States exercises extra-territorial jurisdiction, and a Canadian province."

President Leland: Is it your pleasure that these rules shall govern the conduct of this conference?

Charles W. Gerstenberg (New York): I so move.

President Leland: It has been moved that the rules as read by the secretary shall govern the proceedings of this conference. Is there a second to that motion?

Henry F. Long (Massachusetts): I second the motion.

President Leland: Is there any discussion? There being no discussion, all those in favor say, "Aye."

(Ayes.)

President Leland: Opposed, "No."

(None.)

President Leland: The rules have been adopted.

The next order of business is to hear from our genial and very efficient chairman of the committee on local arrangements. I was asked yesterday if he was the advance agent for the National Tax Association, and I had to say, no, he was not the advance agent, he was the whole thing.

Mr. Raymond H. Berry, chairman of our local committee on arrangements, has done a marvelous job in looking out for your interests and mine by way of recreation, amusement, and providing things to keep our wives busy so that we may discuss these problems. It is with a great deal of pleasure that I introduce Mr. Berry and acknowledge the fine and efficient work that he has done in preparing for this conference.

Raymond H. Berry (Michigan): Mr. President, Ladies and Gentlemen: If I were the mayor of the city of Detroit or the governor of the state of Michigan, I would welcome you to this community of ours. Being neither, I will leave that job to our mayor; and I will say this: that whatever speech he will make will not be a campaign speech, because he is not running for office this year.

The committee on local arrangements has arranged a program designed principally to take care of the ladies. There are two programs, by the way. There is this folder (indicating) which is a so-called entertainment program, and then there is the serious program, which is the blue one. The blue one is for the men, and this one (indicating) is for the ladies. However, it is not limited to the ladies. There are several events that are scheduled to which I will invite your attention, and on which I will ask your cooperation as far as the element of time is concerned.

For instance, this afternoon we have arranged a tea to honor Mrs. Leland and the wives of the other officers and directors of the association, to which all the ladies are invited and urged to be present in order that they may get acquainted with each other. That tea will be held in the Michigan Room on this floor, on the Washington Boulevard side of the building.

Tonight there is a theater program. I dislike to say that it is necessary to make a charge for those theater tickets. The play is "The Women." It is a very fine play and I think you will all enjoy it. It is not limited to the ladies; the men and women are invited, and the reservations may be made in the women's headquarters off the lobby of the ballroom here.

We would like for all the ladies to register in that room. The reason for that is somewhat obvious—our arrangements with the automobile companies and with Dearborn, with Greenfield Village, are such that we must know in order to provide adequate transportation.

In that connection, I would like to say—although I have been told not to do it, I am going to do it—that the transportation that will be provided has been furnished gratuitously by the Ford Motor Company, the Chrysler Motor Car Company, the Packard Motor Car Company and General Motors.

You would think that in a city like Detroit that question of transportation would be no problem at all, but for some reason or other—and I can't explain why—the automobile companies cannot use their own buses or automobiles. They must rent them, and they are all charged on a time basis. The Ford Motor Company is providing a fleet of automobiles, buses, for Wednesday. Those automobiles are charged to the Ford Motor Company. And likewise, the Chrysler Motor Company on Thursday and General Motors on Tuesday.

So the element of time is very important in connection with the plans of the entertainment committee, and if you will cooperate in that connection it will be greatly appreciated, and I am sure it will inure to your benefit and your comfort.

I would like to urge all of you to take in as many of these tours as you possibly can. There is one about which the ladies may say, "No, I don't want to go on that tour." On Thursday, for instance, there is a tour for the ladies through an automobile plant, the Chrys-

ler plant. I dare say there are very few ladies who will be in attendance who have ever been through an automobile plant. In fact, there are very few of them in Detroit who have been through an automobile plant.

The Chrysler Motor Car Company will furnish you luncheon that day at their plant. I think it will be quite unique, and I am sure you will enjoy it. You can go through that plant without any fear of injury or any discomfort, or grease or dirt, or anything else.

We tried to make the program as brief as possible, and I will not take the time to elaborate on the contents. There is one thing that is perhaps not mentioned in the program. If there is anything in Detroit any of you want to see or do, get in touch with some member of the local committee. We will arrange to suit your convenience, trips through any automobile plant, or any other plant in and around Detroit. That includes the steel plants, any automobile plant, or, in fact, any other type of factory that we may have here. If you will just make your wants known, I assure you they will be taken care of if it is possible.

Questions have been asked about Canada. There is no passport required to go in and out of Canada. The customs regulations provide that you may bring into the United States $100 worth of merchandise if you are not a casual visitor, and that means if you are not just going over on one bus and back on another. The unwritten rule is that if you stay there twelve hours you may bring in $100 worth of merchandise, but I have never heard of any of them checking up to see if you have been in there twelve hours. I am not telling you how to avoid the law, but that has been done, although I tell you it is not supposed to be done and that is not the law. Still, that is up to you.

We have not scheduled a trip to Canada because we don't have the time, but anyone wanting to go to Windsor, or any group, if there is a sufficient number, will be provided with a bus.

We have 34 nationalities in Detroit. You may ask some person this or that, and he may say, "No speak English." Well, don't let that discourage you, you start shrugging your shoulder too and you will probably make the fellow understand. But I think most all of them around here will understand your requirements, and if you will just make them known, we will be very happy to arrange whatever you want done.

This is your conference, it isn't ours, and we are here to serve you. Of course, we are very much pleased and honored to have the National Tax Association hold one of its conferences in Detroit.

I think, Mr. President, that is all I have to say. I have attempted to give instructions in this little pamphlet, and I trust that you will read it.

There are two more announcements. We have made arrangements for those who want to play golf. We have some nice golf

courses in and around Detroit. If you have any particular preference, if you will say what golf club you want to go to, you will be sent there. If you have no preference and leave it to us, we will decide.

If any of you men would like to stay at any of the clubs in town, arrangements can be made to issue guest cards to you. The Colony Club, located on Jefferson Avenue, is a women's club. The club has asked me to extend an invitation to all the ladies present to make themselves known if they want to go out to the Colony Club. They will be welcome.

The Women's City Club is across the street here. A similar invitation has been extended to the ladies to make use of the Women's City Club. In fact, I don't know of anything around town that you might want that we can't take care of.

Our common council has designated this as tax conference week in Detroit. Practically all the luncheon clubs have asked for and have been assigned a speaker this week from the membership of the National Tax Association. Some of them meet in this hotel and some meet in other hotels throughout the city. We hope that if we are able to saturate this town with taxes, perhaps we will get rid of some of them.

Thank you very much.

President Leland: In order that Mr. Query, our secretary, might be given credit for one of the functions which he most frequently performs, we had printed on the program that he would make some announcements. It is his turn now.

Secretary W. G. Query: There are two or three things that are of great importance to me in approaching this conference. There are many members of the association who feel that the proceedings should be printed prior to January 1, at least prior to the meeting of the various general assemblies. That has been impossible heretofore for the reason that I have been unable to get hold of some of the papers that were presented at previous conferences.

I have promised these members who have been insisting that we proceed a little more hurriedly with the proceedings that I am going to attempt to get a copy of every paper that will be presented at this conference. All of you who have formal papers, please furnish me a copy either in advance of the presentation or before you leave the room. It will aid me in getting the proceedings in shape.

We have three round tables this afternoon. I would like for the presiding officers of these round tables to see that all formal papers presented at these round tables be turned over to the recording secretary. Those who make remarks, get such remarks in manuscript form, and turn them over to the secretary.

A good many inquiries have been coming to the desk with reference to tickets for the luncheon at twelve-thirty today. I have been

able to get no definite information from the hotel, but I am sure that tickets will be available at the close of this session.

PRESIDENT LELAND: Whether you have a ticket or not, we hope you will attend the luncheon. If for any reason you are overlooked in the purchase of a ticket, or the hotel does not succeed in collecting the price of the luncheon from you, we will not file any informational returns.

The first paper on the program this morning is a review of recent tax legislation by Mr. Raymond E. Manning, attorney at law of the District of Columbia. Mr. Manning hardly needs an introduction to our audiences, he has been preparing these tax legislative reviews for the last few years and their preparation and presentation has been one of the high-spots of this conference.

It is with great pleasure that I present to you this morning Mr. Manning.

STATE TAX LEGISLATION—1938

RAYMOND E. MANNING

Washington, D. C.

Legislatures in 21 states met during 1938 and enacted approximately 350 tax laws.[1]

The year has been outstanding for the lack of new taxes adopted or existing rates increased. The sales tax in Philadelphia is the only new important tax to go into effect.

Especially noteworthy are the initiated constitutional amendments relating to old age pensions, homestead exemptions, rate limitations, etc.

The administration and supervision of all tax laws in Georgia are placed by H. B. 27 in a single revenue commissioner in lieu of the former three-man commission. Mississippi, by H. B. 735, enlarges the duties of the two associate members of the tax commission, who will hereafter be known as the ad valorem commissioner and the excise commissioner. Kentucky extra session H. B. 5, coordinates the functions of the department of revenue.

General tax studies are authorized for the District of Columbia by Public No. 519 and for New Jersey by Chs. 95 and 402. A Maine resolve of October 1937, Ch. 149, provided for a recess committee to study income taxes. Massachusetts Resolve Ch. 38 provides for an investigation of laws relating to apportioning state

[1] This paper includes legislation up to approximately October 10, 1938. At that time, legislative sessions were being held in Arizona, New Jersey and Pennsylvania. The results of any computation of the number of tax laws depend entirely on the view taken as to what is a tax law. For the purpose of this paper, professional licenses and levies under the police power generally are excluded. Notes on the results of the election November 8, 1938 have been added since presentation of paper October 24, 1938.

and county taxes. The New York temporary commission to revise the tax laws was allowed to die, but Ch. 505 created a new commission to study and recommend changes in business taxes. Ohio S. B. 414 provides for a study of a more equitable distribution of the tax burden, and S. B. 420 creates a commission to study the delinquent tax situation.

By Kentucky extra session H. B. 5, Sec. 17, the courts of Kentucky will recognize and enforce statutes concerning taxes constitutionally imposed by other states which extend a like comity.

A proposed Louisiana constitutional amendment,[2] Act 35, provides that all taxes and licenses, other than real property taxes, shall become unenforceable 3 years from December 31 of the year in which due.

Gross Income or General Sales Taxes

A 2 per cent sales and use tax for Philadelphia constitutes the one real important piece of new tax legislation adopted in the United States thus far in 1938. The tax applies to tangible personal property, gas, electricity, refrigeration, steam, telephone and telegraph, and receipts of restaurants and cafes; food, drugs, newspapers and periodicals are exempt. The tax is to expire December 31, 1938.

Louisiana Act 2 is a 1 per cent sales tax to supplant the 2 per cent "luxury tax" enacted in 1936. The tax applies to the sale or use of tangible personal property, but exempts livestock, poultry and other farm products sold directly by producers from farms, and natural gas, steam, water, electricity, newspapers, fertilizer, certain ship chandlers' supplies, and transactions on which an equal or greater tax has been paid in another state. A very similar and additional 1 per cent tax is imposed in New Orleans.

Public No. 519 continues the District of Columbia gross receipts tax and graduates the rate from 1/10 of 1 per cent when the spread between cost and sales price is 3 per cent or less to 4/10 of 1 per cent when the spread exceeds 9 per cent.

In New Hampshire, the constitutional convention has proposed[3] to grant authority to the legislature to impose excise levies on luxury and commodity sales, exempting food, clothing and medicine.

An Arkansas initiated measure[4] reenacts the 2 per cent sales tax and takes 40 per cent of the proceeds for paying old age and blind pensions. An Oregon initiated measure[5] provides pensions for all persons over 65, to be financed by a 2 per cent transactions tax.

[2] Ratified November 8, 1938.

[3] Rejected November 8, 1938.

[4] Ruled off ballot.

[5] Rejected.

California's initiated measure [6] calling for $30 every Thursday to unemployed persons over 50 years of age is to be financed through the medium of retirement compensation warrants and warrant redemption stamps. The warrants will be issued to pensioners who are to spend them like ordinary money. Every Thursday, the holders of the warrants shall affix redemption stamps (to be purchased from the state) in amounts equal to 2 cents for each one dollar of value. At the end of one year, the warrants would be redeemable for one dollar. The warrants are to be accepted in payment of taxes and other obligations to the state and local governments, provided redemption stamps up to date are affixed. The governments then will use these warrants to pay, up to 50 per cent, the salaries of public employees and the cost of materials and supplies purchased. Merchants will not be required to pay a sales tax on goods or services exchanged for warrants, and individuals and business concerns need not pay income taxes to the state on that portion of their income originating from transactions involving the use of warrants. Another California initiated measure [7] proposes a repeal of the sales tax.

Rate changes in various items of the Mississippi sales tax were effected as follows: Chapter 113 establishes the rate on fluid milk at 1 per cent, and includes creosoting and tourist camps in the businesses subject to a 2 per cent tax. Chapter 138 reduces the tax on drain tile and sewer pipe from 1 per cent to 1/4 of 1 per cent. At the Mississippi extra session, the rate on natural gas was jumped by H. B. 104 to 10 per cent until March 1, 1939 and continued thereafter at 2½ per cent. Under the New York City amended tax, the rate on utility services, conduit companies and restaurants checks over $1.00 will be 3 per cent; the tax as to other sales will remain at 2 per cent. An Arizona initiated constitutional amendment [8] proposes to limit taxes for the privilege of engaging in business and measured by volume of business to 20 mills.

A compensating tax for the privilege of using, storing or consuming within Mississippi tangible personal property purchased at retail outside the state is imposed by Ch. 114 at the same rates as for the sales tax. South Carolina H. B. 2050 imposes a tax on the importation, receipt, or acquisition of tobacco products, playing cards, cartridges and shells from without the state for use or consumption within. Ohio H. B. 761 redefines "use" to exclude tangible personal property used directly in the production of crude oil and natural gas and in floral culture.

Exemptions from sales taxes have been adopted as follows: Kansas S. B. 90 exempts sales of property used exclusively for state, county, municipal, educational, charitable and religious purposes;

[6] Rejected November 8, 1938.

[7] Rejected November 8, 1938.

[8] Ruled off ballot.

the exemption is disallowed when the beneficiary is engaged in a taxable business. Mississippi, by Ch. 126, exempts sales by retail dealers of mules, horses, and other live stock, by Ch. 248 exempts non-profit corporations, or non-profit co-operatives distributing electrical current, and by extra sessions S. B. 36 exempts freight shipments of commercial fertilizers moving at intrastate rates within the state. New York City eliminates the $15,000 and $5,000 existing exemptions under the business gross receipts tax, but exempts commercial business when the gross receipts do not exceed $10,000. Ohio H. B. 760 removes the general exemption to purchases, by non-residents, but extends a specific exemption to ice, gas-filled dirigibles, vessels, hearses and ambulances purchased by non-residents for use outside the state.

Gasoline Taxes

The temporarily increased rate of gasoline tax in Rhode Island was made permanent by H. B. 386, and the temporary rate of Massachusetts was continued by Ch. 431, and that of New York by Chs. 63 and 64. An Arizona initiated constitutional amendment [9] limits the rate of tax to 5 cents a gallon. Missouri, by an initiated constitutional amendment,[10] proposes to fix the rate of tax at 3 cents until 1948. A constitutional amendment proposed by the Louisiana legislature,[11] Act 39, and amendments initiated in Arkansas [12] and Montana [13] pledge continuance of existing rates as inducements for new bond issues or refunding of old. Mississippi H. B. 493 imposes a 6 cents per gallon tax on operators of vehicles when using fuel other than gasoline. A 3 cent per gallon tax on airplane fuel is levied under Virginia Ch. 368. Mississippi H. B. 1012, exempts 5 cents of the 6 cent tax on gasoline sold to airplanes engaged in interstate commerce, and H. B. 374 reduces the tax on oil, which includes kerosene, fuel oil, distillate and gas oil from 1 cent to ½ cent per gallon, imposes a tax on liquid fuel gas of ⅛ cent, and allows a refund on gasoline used for non-highway purposes. Virginia Ch. 299 provides for refunds to cover shrinkage and evaporation for transfers by truck from water terminals to bulk storage tanks. By Ch. 159, New York provides that there shall be no refund for fuel carried outside the state in one's car. Virginia Ch. 312 provides for taxing gasoline on United States military or other reservations when not for the exclusive use of the United States.

The use of all revenues from gasoline and motor vehicles for highway purposes is required by an Alabama constitutional amend-

[9] Ruled off ballot.

[10] Rejected November 8, 1938.

[11] Ratified November 8, 1938.

[12] Rejected November 8, 1938.

[13] Ratified November 8, 1938.

ment[14] proposed by the 1936-37 legislature (Act 94), by a California constitutional amendment[15] proposed by the 1937 legislature (S. C. A. No. 28), by an initiated constitutional amendment[16] in Michigan, and by an amendment[17] proposed by the New Hampshire Constitutional Convention. New York Ch. 579 permits counties to use motor fuel tax revenue in 1938 and 1939 for debt service on highway bonds and for snow removal on state highways. Illinois H. B. 1, allows diversions for relief purposes. By Louisiana Act 19, one-half the monthly parish and gasoline tax revenues shall be spent for state welfare purposes and one-half shall be apportioned to the parishes as heretofore; formerly, all such revenues were used for local purposes.

Alcoholic Beverage Taxes

New or increased taxation of alcoholic liquors is provided by Arkansas Act 18, Georgia H. B. 196, District of Columbia Public No. 519, Kentucky H. B. 37, Louisiana Act 44, Mississippi extra session H. B. 151, Ohio S. B. 462, New Jersey Ch. 319, and South Carolina Act 1201. Kentucky H. B. 401 allows wine and whiskey wholesalers a 3 per cent discount for affixing liquor tax stamps (now applicable only to wholesalers and brewers of beer) to cover expenses, and Kentucky extra session H. B. 15 authorizes the department of revenue to require use of crowns in collection of beer taxes.

Tobacco Taxes

A tax on cigarettes of 1 cent per 20 is imposed by New York City. Mississippi extra session H. B. 152 taxes cigarettes at 1/5 cent each instead of 1 cent per 5 and prescribes a new rate on cigars of 1 cent for each 5 cents instead of those prescribed at the regular session by H. B. 966 that ranged from $0.75 to $13.50 per 1000. The rate of tax in South Carolina on cigars weighing more than 3 pounds per 1000 and retailing for not more than 3 1/3 cents was reduced from $10 to $3. per 1000. A proposed initiated Arizona constitutional amendment[18] limits the tax on tobacco to 10 mills per ounce, 20 mills on 20 or less cigars weighing 3 pounds or less per 1000 and upon 20 or less cigarettes, 10 mills on each 3 cigars weighing over 3 pounds per 1000 and selling for 5 cents or less and upon each cigar selling at more than 5 cents. Kentucky H. B. 233 extends to non-resident wholesalers the 10 per cent commission allowed resident wholesalers for affixing cigarette stamps.

[14] Rejected November 8, 1938.
[15] Ratified November 8, 1938.
[16] Ratified November 8, 1938.
[17] Ratified November 8, 1938.
[18] Ruled off ballot.

Amusement Taxes

An initiated Oregon constitutional amendment [19] legalizes lotteries and other forms of gambling, and authorizes their taxation. An Arizona initiated measure [20] limits the taxes on horse racing to 5 per cent of the gross receipts from all sources. New Jersey Ch. 57 authorizes the boxing commission to reduce from 10 per cent to 5 per cent the gross receipts tax on championship boxing and wrestling matches. Kentucky H. B. 133 exempts municipal swimming pools and public bathing places from the admissions tax, and South Carolina S. B. 1194 charges public bathing places a flat $15 in lieu of a per capita admissions tax. Another South Carolina Act, H. B. 2084, exempts professional baseball games from the admissions tax in 1938. Ohio, by S. B. 242, extends its admissions tax to February 1942. A Philadelphia Ordinance imposes an amusement tax at the rate of 1 cent per 25 cents, and Louisiana Act 212 reenacts for 2 years legislation authorizing New Orleans to levy an amusement tax.

Miscellaneous Sales Taxes

Louisiana Act 259 changes the 20 per cent tax on lubricating oils to a flat rate of 8 cents per gallon (4 cents when sold in lots of 50 gallons and used on farms), and Act 361 levies a tax of 20 cents per gallon on petroleum solvents. Another Louisiana act, No. 34, repeals the tax on butter, butter substitutes, cheese, ice cream, canned and powdered milk, milk products, edible beef, veal meats and their by-products.

Inheritance and Estate Taxes

The additional rates of death duties in Massachusetts and New York were continued by Ch. 502 and Ch. 68, respectively, and the operation of the New Jersey Act involving inheritance tax adjustments was extended to June 30, 1939 by Ch. 136. Congress, by Public No. 519, includes real and tangible personal property of non-residents that have acquired a taxable situs in Washington in computing the district estate tax. A resolution [21] of the New Hampshire Constitutional Convention proposes to empower the legislature to impose graduated and progressive taxes on property passing at death.

Personal Income Taxes

Authority to impose a graduated and progressive income tax at rates not exceeding 6 per cent is proposed [22] by the New Hampshire Constitutional Convention. Maryland [23] and Washington [24] will vote

[19] Rejected November 8, 1938.
[20] Rejected November 8, 1938.
[21] Rejected November 8, 1938.
[22] Rejected November 8, 1938.
[23] Rejected November 8, 1938.
[24] Rejected November 8, 1938.

on proposals of their 1937 legislatures to amend their constitutions so as to authorize graduated income taxes.

Rates are increased in Mississippi by H. B. 651 to range from 3 per cent to 6½ per cent instead of 2½ per cent to 6 per cent, the maximum applying on all over $15,000. New York Ch. 66 continues the emergency 1 per cent tax for another year and Massachusetts, by Ch. 502, continues its additional levy equal to 10 per cent of the computed tax. Georgia S. B. 19, deletes the minimum tax provisions. An Arizona initiated constitutional amendment[25] limits graduated net income tax rates to 25 mills on the first $3,000 and 50 mills on all over $3,000.

Personal exemptions in Mississippi are raised by H. B. 134 to the federal level in lieu of the former $750, $1,500 and $200 basis. An exemption of $400 is allowed by Louisiana Act 229 for each child or ward between 18 and 21 years to whom educational opportunities are offered. By South Carolina H. B. 1854, the exemption from surtax on dividends and interest was increased from $200 to $500 and the tax is extended to apply to income received by any individual through estates, trusts or fiduciaries.

Capital gains and losses in New York are segregated from ordinary net income, by Ch. 511, and losses are made deductible only from gains. Net capital gain income is then taxed according to the existing income bracket schedule but at one-half the prescribed rates.

Miscellaneous other provisions follow. Georgia S. B. 19 changes the definition of resident to include persons residing in the state for 4 instead of 6 months and authorizes deduction of federal net income taxes due and paid during the immediately preceding year. Kentucky extra session H. B. 46 eliminates the provision imposing a 6 per cent interest penalty on taxes paid in installments. Massachusetts Ch. 489 provides for taxation of dividends, except certain stock dividends, during 1939 and 1940. Louisiana Act 231 authorizes the collector of revenue to require the withholding of taxes at the source by those having control of the payment of rent, salaries, annuities, compensation, etc.

Corporation Income Taxes

Rates of corporation income taxes are increased in Mississippi by H. B. 651 to range from 3 per cent to 6½ per cent instead of 2½ per cent to 6 per cent and the flat exemption of $750 is raised to $1,000 by H. B. 134. Massachusetts Ch. 502 continues the additional levy equal to 10 per cent of the computed tax and Ch. 489 continues the minimum tax on domestic corporations dealing exclusively in securities. New York by Ch. 71, extends the 6 per cent rate on corporations for another year, and, by Ch. 72, also continues the 4 per cent tax on unincorporated business. Georgia S. B. 19,

[25] Ruled off ballot.

repeals the $10 minimum tax and authorizes a deduction for federal income taxes paid during the immediately preceding year. New York, by Ch. 541, amends the paragraph relating to the formula to be used in computing the minimum tax by providing that cash on hand and on deposit are eliminated from gross assets in allocating the portion of issued capital stock subject to the minimum.

Miscellaneous other corporate income tax acts follow. By Massachusetts Ch. 489, the credit for dividends paid to residents by foreign corporations will not be allowed in 1939 and 1940. New York Ch. 201 establishes a new mode for taxing investment trusts, viz: 4½ per cent of net income, 1 mill on issued capital stock, or $25, whichever is greater. A proposal [26] of the New York Constitutional Convention prohibits the taxation of undistributed profits. The convention also proposes [27] to forbid discrimination between federal corporations that the state has a right to tax and other corporations doing business in the state.

Bank Taxes

Stock of branch banks in incorporated towns may be assessed a "proportionate" tax under Virginia Ch. 291. Louisiana Act 173 provides for a supplemental method of assessing bank shares where the bank operates branches in different municipalities wholly within the limits of the parish of legal domicile, and for apportionment of the tax among municipalities based on deposits. Another Louisiana Act No. 172, reenacts legislation relative to the taxation of bank shares, and provides for the assessment to shareholders at the domicile or location of the bank and for payment by the banks who are to collect from the shareholders. The stock, instead of being valued by the assessor, shall be assessed by the tax commission for state and local purposes; provisions requiring assessment at actual value or the same percentage of actual value as that of other property are deleted. By Georgia H. B. 25, no building and loan association shall be taxed on its franchise, capital, reserves, surplus, loans, shares, or accounts.

Insurance Taxes

Domestic stock insurance companies other than life will be taxed under New Jersey Ch. 245 in the taxing district where their office is situated upon the full value of their taxable intangible property (exclusive of all shares of stock owned) deducting all debts and liabilities, reserves for taxes, and such proportion of reserves as the full value of all their taxable intangible property in the state bears to the full value of all their intangible property. Another New Jersey Act, Ch. 186, makes it definite that returns to the state tax commissioner are not required of fire insurance companies

[26] Ratified November 8, 1938.

[27] Ratified November 8, 1938.

and stock insurance companies other than life insurance companies. New York Ch. 718 reduces the fire department tax on foreign insurance companies to the rate of $1.80 per $100 on all premiums received during the year, and Ch. 128 specifically exempts from the franchise tax on insurance companies only such corporations as charitable, religious, missionary, educational or philanthropic non-stock corporations. Mississippi H. B. 1045 reduces the tax on foreign insurance companies by one-third if one-fifth of their entire assets are invested in securities or property of the state or local units.

Reinsurance provisions are variously amended. Arkansas Act 4 reenacts the 2 per cent annual tax on premiums collected on insurance policies written by foreign fire and casualty companies in order to restore to the firemen's pension fund money lost under a nullified tax on policies reinsured. California S. C. A. 1 (a proposed constitutional amendment,) [28] and Virginia Chs. 38 and 39 amend the gross premium tax on insurance companies to provide for the collection of a tax on reinsurance from the direct insurer instead of the company carrying the reinsurance.

Kentucky H. B. 241 deletes a provision that premiums paid for reinsurance on business to companies authorized to transact business in Kentucky shall be deductible in computing gross premiums, and H. B. 243 includes in the measure of taxes reinsurance on Kentucky risks received from unauthorized companies. Reinsurance premiums received will be exempt under District of Columbia Public No. 519, Mississippi H. B. 1045, and New Jersey Chs. 55 and 56. All this legislation is probably to meet the supreme court decision in Connecticut General Life Insurance Co.—vs.—Johnson, 303 U. S. 77.

Public Utility Taxes

The New York 2 per cent gross income tax on utilities was continued by Ch. 67 for another year, and the power of cities to impose a 1 per cent levy was similarly extended by Ch. 65; motor carriers are excepted by Ch. 710 from the state tax. The Illinois utility tax was amended by H. B. 3 to prolong the 3 per cent levy now imposed on telegraph, telephone, gas and electric companies to July 1, 1939; the moneys collected are to be paid into the state emergency relief fund until that time. By Ohio H. B. 741 of the 2nd special session, as last amended by H. B. 462 of the 3rd special session, there is imposed for 4 years an additional poor relief tax of 65/100 of 1 per cent on the gross receipts of electric light and power, intrastate toll bridge, gas, natural gas, waterworks, telephone, union depot, heating, cooling, water transportation and express companies, a $25,000 deduction being allowed for each electric light and power, gas, natural gas and telephone company; a tax for the same period is

[28] Ratified November 8, 1938.

imposed on the allocated capital stock of sleeping car, freight line and equipment companies at the rate of 15/100 of 1 per cent.

Over the veto of the governor of New Jersey, the legislature enacted bills which revise the method of apportioning to local units gross receipts and franchise taxes levied on utility companies, increase the state school tax rate from $2.75 to $2.90 per $1,000 valuation, and empower the state tax commissioner to fix the valuation of public utility property in each community as a basis for allocating the revised 5 per cent gross receipts tax (2 per cent if gross receipts not over $50,000) enacted in lieu of a personal property tax.

Miscellaneous other changes in the public utility tax laws follow: Louisiana Act 182 exempts tugs and launches from the public utility tax, and Virginia Ch. 280 changes the tax on corporations operating freight or passenger steamers from a flat 1½ per cent gross receipts levy to 1 per cent on receipts up to $400,000, and 2 per cent on sums above that amount. Another Virginia Act, Ch. 33, limits the use of revenue from certain levies on public service companies to appraisals, valuations, investigations, and inspections of such companies. Louisiana Act 161 authorizes the tax commission to value and assess gas and oil pipe lines, electrical transmission lines, water and gas distributing systems and chain stores. Mississippi, by H. B. 661 and extra session H. B. 122, exempts non-profit co-operative associations engaged in distributing electrical current from certain taxes.

Severance Taxes

Louisiana Act 395 is a proposed constitutional amendment [29] to limit the severance tax on sulphur to $1.03 per ton and to limit assessments on sulphur deposits to twice the valuation of property above the ground. By an Arizona initiated measure,[30] severance taxes are not to exceed 20 mills on the dollar.

Poll Taxes

Kentucky H. B. 155 exempts 90-day disabled veterans from poll tax. Massachusetts Ch. 186 repeals the outright exemption of males over 70 from the poll tax, substituting in lieu thereof an exemption to such persons over 70 who received old age assistance or municipal aid during the preceding year and who request to be exempt from the tax. A proposed Arkansas constitutional amendment [31] abolishes the poll tax as a requirement for voting.

Colorado proposes through the initiative to repeal the chain store tax.[32]

[29] Ratified November 8, 1938.

[30] Ruled off ballot.

[31] Ratified November 8, 1938.

[32] Rejected November 8, 1938.

Single Tax

A modified single tax is proposed by a California initiated constitutional amendment.[33] The measure repeals limitations on ad valorem property taxes for state appropriations; prohibits increasing present assessed valuation of improvements and tangible personal property, annually reduces the tax thereon, and exempts $1,000 of assessed improvements on land occupied by the owner as a home; limits tax moratoriums to improved property in one parcel and ownership having an assessed valuation not exceeding $5,000; repeals sales, use, and private car taxes.

Property Taxes

The aggregate rate of tax for state and local purposes in Washington is not to exceed 40 mills (state not to exceed 2 mills) on a 50 per cent valuation under an initiated measure[34] reenacting the existing law. Arizona, also through the initiative proposes[35] that (except for outstanding bonds and general serial obligation bonds hereafter issued and authorized by vote of the real property taxpayers) tangible property for state purposes shall not be taxed to exceed 5 mills, for counties with a valuation not over $30,000,000, not to exceed 20 mills, and for counties over $30,000,000 not to exceed 10 mills.

Removal of the required South Carolina 3 mill property tax or other state-wide property levy for school purposes is proposed by H. B. *2217* (constitutional amendment).[36] Initiated Missouri measures[37] eliminate the state tax on property except for paying the bonded debt, provide for the gradual elimination of local property taxes for schools, and require the general assembly within 6 years to provide for financing schools. A measure of the 1937 Florida legislature to be voted upon[38] proposes to require that provision be made for raising revenue to defray state appropriations made for the benefit of a uniform system of free public schools, and of the state institutions of higher learning as a part of the expenses of the state and on an equality therewith. A proposal[39] of the New Hampshire Constitutional Convention authorizes the classification and taxation at a special rate for stock in trade and machinery in order to maintain and encourage the development of industry and business.

[33] Rejected November 8, 1938.
[34] Ratified November 8, 1938.
[35] Ruled off ballot.
[36] Result undetermined—actual outcome dependent on official canvass.
[37] Rejected November 8, 1938.
[38] Ratified November 8, 1938.
[39] Rejected November 8, 1938.

Assessment of Property

Assessments of lots at actual value as of January 1, following subdivision, without regard to former value as acreage, is required by Virginia Ch. 91. Louisiana Act 113 provides additional procedure for cancellation of erroneous assessments. A one-man board of tax appeals was established by congress for the District of Columbia under Public No. 519.

Georgia H. B. 29 authorizes local units to set up boards of tax appeals and requires that the remedy before them be exhausted before appeal to the courts. By an Arizona initiated constitutional amendment,[40] state lands sold on certificate of purchase shall be subject to taxation only for the total amount paid to the state in addition to improvements.

Intangible Property Taxes

Georgia H. B. 26 classifies intangibles and prescribes the following rates: (1) 10c. per $1,000 on cash or money on deposit; (2) $3 for $1,000 for stocks, bonds or notes secured by real estate mortgages, except stocks of Georgia corporations which have paid ad valorem taxes; (3) $1.50 per $1,000 on first $5,000 ($3 on additional amounts) of deposits in building and loan associations insured by the Federal Housing Administration.

By Kentucky extra session H. B. 10, all intangibles shall have a situs and be taxable in Kentucky so far as the general assembly can constitutionally subject them to taxation. Another Kentucky Act of the extra session, H. B. 43, imposes a tax of 10 cents per $100 on the direct or contingent indebtedness of customers to brokers making purchases or sales in margin transactions.

An Arizona initiated proposed constitutional amendment [41] limits the rate of tax on intangibles to 4 mills, except that money, deposits, gross credits, checks, etc. may be taxed at not exceeding 1 mill. None of the foregoing is applicable to bank stock or stock of other corporations using money to make money, but such stock shall be assessed at market value and taxed at rates not exceeding those for tangible property.

The New York Constitutional Convention has proposed [42] that intangible personal property shall not be taxed on an ad valorem basis or by an excise tax.

Exemption from Property Taxes

Homestead exemptions are granted in one additional state, proposed by constitutional amendment in two states, and increased in a fourth state. Georgia is the new state, S. B. 2 allowing a $2,000 exemption to owner-occupied homes and farms from state, county

[40] Ruled off ballot.

[41] Ruled off ballot.

[42] Ratified November 8, 1938.

and county school district taxes. An initiated Arizona constitutional amendment[43] proposes a $5000 exemption, while a Missouri initiated measure,[44] effective 4 years after ratification, exempts homes and furniture, the replacement cost of which does not exceed $5,000, and land, the value of which does not exceed $2,500. A Florida proposal[45] of the 1937 legislature broadening the exemption base in a minor detail will also be voted upon. Mississippi, by H. B. 2 of the special session, jumps its exemption from $2,500 to $5,000 and applies it to all ad valorem taxes levied by the state or levied for maintenance and current expenses of counties, municipalities, school districts and road districts.

All new homes built, or improvements made, after January 1, 1938 in Louisiana on which prevailing wages were paid for construction will be exempt from taxation for 3 years succeeding completion under the constitutional amendment[46] proposed by Act 38. Mississippi H. B. 184 exempts household furniture kept in the home, all farm implements used exclusively in the cultivation or harvesting of crops, removes the limitation on exemptions of guns, poultry and live stock, and adds horse drawn vehicles kept for use of the owner and boats, seines and fishing equipment used in fishing.

Exemptions to new industry are being both extended and retricted. The 10-year exemption Mississippi municipalities have been authorized to grant is reduced to 5 years by H. B. 464. In Louisiana, the 10 year exemption granted by the state is continued, but new contracts for exemption may not be entered into more than 3 years after ratification of the constitutional amendments[47] proposed by Act 37. Mississippi extra session S. B. 77 adds to the exempt list manufacturers of roofing, steel drums, metal fabrication, chemical wood work, golf clubs, textile shuttles, and sheet metal, and plants for storage, warehousing and compressing of cotton and other agricultural products. Arkansas H. C. R. 4 declares it to be the opinion of the assembly that the 7-year exemption to textile mills applies to all fibre manufactured from cotton, corn, wood, rice, straw, soy beans and others from which cellulose is obtained. An initiated Arkansas constitutional amendment[48] proposes to permit 10-year exemptions to new manufacturing establishments or additions to old ones. Mississippi H. B. 1092 exempts growing timber less than 12 inches in diameter from ad valorem taxes. Another Louisiana constitutional amendment[49] proposed by Act 41, exempts certain bridges thereafter erected across the Mississippi River under congressional authority, where provision is made for present or future toll-free operation.

[43] Rejected November 8, 1938.

[44] Rejected November 8, 1938.

[45] Ratified November 8, 1938.

[46] Ratified November 8, 1938.

[47] Ratified November 8, 1938.

[48] Ratified November 8, 1938.

[49] Ratified November 8, 1938.

United States property will be exempt under Massachusetts Ch. 47 so far as taxation is constitutionally prohibited; it was formerly exempt if constitutionally held and used for essential government purposes. Service charges in lieu of taxes on housing authorities are provided for by California Ch. 1, Illinois S. B. 38, and Massachusetts Ch. 484. Louisiana, Chs. 274 and 356, and Mississippi, by S. B. 134, authorize their tax commissions to negotiate agreements for in lieu payments on lands acquired for rural rehabilitation and resettlement.

Three new local associations are added to the exempt list by Virginia Ch. 296, and Public No. 435 adds the Society of the Cincinnati and Public No. 642 adds Y. W. C. A. property to the District of Columbia non-taxables. Massachusetts Ch. 317 grants a $5,000 exemption to parsonages. The New York Constitutional Convention proposes [50] to guarantee religious institutions against alterations of exemptions.

Improperly exempt property is the subject of an investigation by the New Jersey Tax Commission under A. J. Res. 2; the commission is to return such property to the rolls and present a report to the governor and legislature.

Miscellaneous and other exemption statutes follow. Georgia S. B. 1 grants a $300 exemption to all personal property. New Jersey Ch. 390 exempts all moneys in banks belonging to persons or firms individually or in a fiduciary capacity and Louisiana Act 199 (a proposed constitutional amendment,[51]) exempts boats using gasoline as motor fuel. An initiated Missouri constitutional amendment [52] prohibits local property taxes on motor vehicles. By Mississippi extra session S. B. 36, all goods in or about to enter interstate or foreign commerce are made exempt from ad valorem taxation.

Collection of Property Taxes

Relief to property owners assumes a variety of forms. The time for paying certain taxes due in 1938 was extended by Louisiana Act 399 and South Carolina H. B. 1790. Authority was granted Virginia cities, towns, counties, and districts by Ch. 94 and Ch. 98 to remit penalties on delinquent taxes for 1937 and previous years if the taxes are paid by December 5, 1938. Tax sales for 1938 were postponed by Mississippi H. B. 333 and Pennsylvania S. B. 14. An act in Virginia Ch. 230, authorizes cities and counties to postpone sales in any year not to exceed 3 years from the time otherwise fixed therefor. Extension of periods of redemption for property already sold and permission to make payments for taxes on such property in instalments, are granted by California Ch. 17 and Louisiana Act 47. Ohio H. B. 828 authorizes instalment payment

[50] Ratified November 8, 1938.
[51] Ratified November 8, 1938.
[52] Rejected November 8, 1938.

of delinquent taxes and discount for prompt payment. The rate of interest on unpaid taxes is reduced in Massachusetts by Ch. 330. Ohio H. B. 746, extends for another year an act authorizing deductions from taxes owed by landlords in consideration for rent on houses occupied by persons on relief.

More effective remedies are granted for collection of taxes. Louisiana Act 112 authorizes municipalities to enforce taxes on property adjudicated to it by leasing or renting the property with right of sale after expiration of the redemption period. Another Louisiana Act, No. 111, provides that property adjudicated to the state shall continue to be assessed during the period allowed by law for its redemption. Virginia Ch. 293, makes specific provision for enforcing tax liens on real estate by suits in equity, and Ch. 292 provides that in certain suits for collection the benefit of purchase and any claim to title may be waived and reliance placed solely on the lien. Kentucky extra session H. B. 42 reduces the time for redeeming from tax sales from 5 years to 2 years and allows sheriffs to sell either real or personal property for taxes instead of requiring them to dispose of personal property first. By Mississippi extra session S. B. 25, municipalities may tax all taxable property that has escaped taxation within the last 7 years, upon 10 days notice; provision is made for sale, and redemption within 2 years. Louisiana Act 280 makes it the duty of the supervisor of public funds to take charge and control of the office of any tax collector, whenever such office becomes vacant, and to perform the duties thereof until it is filled.

Miscellaneous other acts follow: California Ch. 23 regulates tax sales, tax deeds and redemptions, giving the controller general supervision over the procedure. Louisiana, Act 235 provides for homesteading property adjudicated to the state for non-payment of taxes, and act 330 provides a remedy at law in lieu of direct refund for recovery of taxes illegally exacted and for the protection of rights that may be alleged to be infringed under the tax laws of the state. New Jersey Ch. 26 authorizes municipalities to adjust or abate taxes owing from corporations under the jurisdiction of receivers or trustees appointed by a federal district court, or under the bankruptcy laws of the United States, or the New Jersey Court of Chancery.

President Leland: I want to thank you, Mr. Manning, for that very excellent presentation.

For the benefit of those of you who came in late, let me say that Mr. Manning's paper has been mimeographed and will be available at the registration desk.

The hotel authorities have become worried. They have seen so many come in here that they are trying to get an idea as to the number of setups that should be provided at their luncheon. Will

those of you who intend to go to the luncheon hold up your hands so that we may get some idea as to the size of the crowd?

(About 90 hands were raised)

The next paper on the program this morning is a judicial review. Mr. Traynor, professor of Law at the University of California, is going to give us a review of the recent decisions by the United States and other courts, and is omitting by request all reference to cases concerned with the doctrine of implied immunity, with particular reference to the taxation of governmental instrumentalities and the salaries of public officials. The law with reference to those particular points in the decisions will be covered this evening by Professor Rottschaefer, of the University of Minnesota.

Mr. Traynor's paper has been printed, and copies of his complete paper will be available also at the registration desk at the close of this session.

Mr. Traynor, it gives me great pleasure to present you to this audience. I think that Roger has done such a good job heretofore in his analyses of these decisions that we hardly need to give him a lengthy introduction. His work speaks for itself.

TAX DECISIONS OF THE SUPREME COURT, 1937 TERM

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Nearly one third of the cases upon which the supreme court rendered written opinions in its 1937 term involved controversies over taxes. They constituted by long odds the largest single group of cases to have travelled the long road of litigation culminating in the deliberations of the highest court. The result has been not only a substantial addition to the already ponderous mass of tax law but the clarification of certain problems left open by previous decisions. There remain to be solved, however, not only many old problems but also a number of new ones growing out of the latest opinions. The difficulties ahead, together with the present maze of tax decisions, warrant taking an inventory of what the court has accomplished in the past year and charting whatever trends seem definite enough to play a part in the consideration of future problems.

Those cases dealing with intergovernmental tax immunity will not be discussed here, as they constitute a separate problem to be dealt with by Mr. Rottschaefer. Apart from them, decisions of great importance have been made on the restrictive effect of the commerce clause, the fourteenth amendment and the impairment of contracts clause upon state taxation, the implications of the sixteenth amendment, and the construction and application of various provisions of the federal revenue laws.

COMMERCE CLAUSE

Although not abandoning the usual and frequently formalistic methods of approach the court in several opinions has used language that may well presage the future abandonment of old rules and the application of a new test to determine whether or not a state tax violates the commerce clause. Under this test certain elements which have in the past been regarded as part of the pattern if not the fabric of interstate commerce will not be entitled to exemption from a non-discriminatory state tax even though their taxation admittedly increases the cost of carrying on interstate commerce so long as sustaining the tax will not lead to multiple state taxation.[1]

Western Livestock v. *Bureau of Revenue* [2] is probably the most important case of the last term pointing in this new direction. The New Mexico tax before the court in that case was imposed upon the business of publishing newspapers and magazines and was measured by gross receipts from advertising. The advertising contracts were made with advertisers in other states and necessitated the interstate transmission of advertising materials from advertiser to publisher [3] and the gross receipts from advertising were greater by reason of the publisher's maintenance of an interstate circulation of the magazine containing the advertisements. The court assumed in favor of the taxpayer that the advertising contracts required the publisher to maintain this interstate circulation.

The tax was upheld, the first ground being that "providing and selling advertising space in a publication," was a local business distinct from the business of circulating the publication.[4] The court

[1] As early as 1867 in Steamship Company v. Portwardens, 6 Wall. (73 U. S.) 31, the court recognized that a forbidden burden on interstate commerce might result if a fee were imposed upon every ship entering the port of New Orleans, as a similar fee might then be exacted at every port of call.

[2] (1938) 58 Sup. Ct. 546. See comments (1938) 86 U. of Pa. L. Rev. 787; (1938) 13 Indiana L. J. 500.

[3] It was held "the tax . . . is not forbidden either because the contract, apart from its performance, is within the protection of the commerce clause, or because as an incident preliminary to printing and publishing the advertisements the advertizers send cuts, copy and the like to appellants." It is well established that the mere formation of a contract between persons in different states is not within the protection of the commerce clause. See Paul v. Virginia (1868) 8 Wall. 75 (U. S.) 168, and other cases cited by the court. A more difficult problem arises when articles must be transported preliminary to performing a contract, such interstate movement from buyer to seller being necessary to the performance of the contract.

[4] It has been suggested that as the business taxed was printing and publishing and as publishing included notification of persons outside the taxing state, the case was governed by Fisher's Blend Station v. Tax Commissioner (1936) 297 U. S. 650. See 86 U. of Pa. L. Rev. 787. The court, however, viewed the tax as "conditioned on the carrying on of a local business, that of providing and selling advertizing space in a published journal." If this view, which is not clearly apparent from the language of the taxing statute

found sufficient authority for its holding in *American Manufacturing Company* v. *St. Louis*,[5] which sustained a state tax upon manufacturing measured by total sales most of which were in interstate commerce.[6] The court also upheld the tax on the ground that, unlike the tax sustained in the *American Manufacturing Company* case, it did not include in its measure the gross receipts from goods sold in interstate commerce. The burden on interstate commerce resulting from taxing receipts from advertising even though augmented by interstate circulation, was considered too remote to affect the validity of the tax, the inference being that gross receipts from advertising are taxable independently of a local privilege.

Perhaps the greatest interest attaches to the court's "added reason" for sustaining the New Mexico tax, namely, that in so far as the additional value of gross advertising receipts resulting from interstate circulation is taxed by New Mexico "it cannot again be taxed elsewhere any more than the value of railroad property taxed locally." Whatever interstate commerce might be involved in the business taxed, therefore, could not be jeopardized by cumulative burdens.

This added reason coupled with the court's emphasis on the fact that interstate commerce is not wholly exempt from state taxation but must pay its way,[7] together with the court's striking declaration that the reason for invalidating state taxes on gross receipts from interstate commerce and other interstate values is to prevent discrimination against interstate commerce resulting from multi-state

set forth in a footnote to the opinion, is tenable, the tax can be distinguished from the tax on radio broadcasting invalidated in the Fisher's Blend case.

[5] (1919) 250 U. S. 459.

[6] Once a local privilege has been defined there remains the problem of measuring its value. Where the privilege is that of producing something, its value may be measured by the number of things produced over a given period of time. Utah Power & Light Co. v. Pfost (1932) 286 U. S. 165, production of electricity measured by amount generated; Coverdale v. Arkansas-Louisiana Pipe Line Co. (1938) 58 Sup. Ct. 736, production of power measured by horse-power of producing engine. The privilege may also be measured by the value of the things produced over that period. Oliver Iron Mining Co. v. Lord (1923) 262 U. S. 172, production of ore measured by value of the ore mined. Amongst the criteria of the value of a thing is its sale price. Thus gross sales, reflecting as they do the value of that which is sold, are an appropriate measure of the value of the privilege of producing that which is sold. Hope Natural Gas Co. v. Hall (1926) 274 U. S. 284, production of gas, measured by gross receipts from sales of the gas produced; American Mfg. Co. v. St. Louis (1919) 250 U. S. 459, production of goods measured by gross receipts from sales of the goods produced.

[7] "It was not the purpose of the commerce clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing the business. 'Even interstate commerce must pay its way.'" 58 Sup. Ct. at 548.

taxation of the same values,[8] suggests that it is no longer necessary to find a local privilege to uphold a tax on gross receipts from interstate commerce where multi-state taxation of these gross receipts is impossible.

This suggestion is fortified by the decision in *Adams Manufacturing Co.* v. *Storen.*[9] This case involved the Indiana gross income tax as applied to gross receipts from interstate sales. The tax on such receipts was invalidated, not on the grounds that they are immune from state taxation except where the tax is merely the equivalent of a tax on property or some other subject within the jurisdiction of the state, but on the ground that such receipts were taxed without apportionment.[10] Such a tax if upheld would result in discrimination against interstate commerce as other states in which the commerce is carried on could with equal right tax the same gross receipts. The plain inference to be drawn from the case, in line with the Western Livestock case, is that if the tax had been so apportioned as to avoid the possibility of a cumulative burden resulting from multi-state taxation of the same gross receipts, it would have been valid. Thus, just as a state may tax net income from interstate commerce fairly attributable to the state so may it tax gross receipts fairly attributable thereto even though the tax is not on a local privilege or in lieu of a property tax.[11]

A discussion of the above cases would not be complete without some mention of the vigorous dissenting opinion of Mr. Justice

[8] "The vice characteristic of those which have been held invalid is that they have placed on commerce burdens of such a nature as to be capable in point of substance of being imposed or added to with equal right by every state which the commerce touches merely because interstate commerce is being done, . . . It is for these reasons that a state may not lay a tax measured by the amount of merchandise carried in interstate commerce, or upon the freight earned by its carriage." 58 Sup. Ct. at 548-9.

[9] (1938) 58 Sup. Ct. 913. The probable bearing of the Western Livestock case upon the decision in this case is discussed in (1938) 13 Indiana L. J. 500.

[10] "The vice of the statute as applied to receipts from interstate sales is that the tax includes in its measure, without apportionment, receipts derived from activities in interstate commerce." 58 Sup. Ct. 913, 916.

"It is because the tax, forbidden as to interstate commerce, reaches indiscriminately and without apportionment, the gross compensation for both interstate commerce and intrastate activity that it must fail in its entirety so far as applied to receipts from sales interstate." 58 Sup. Ct. 913, 917.

[11] This inference raises the question as to what sort of an apportionment would have satisfied the court. See Hump Hairpin Mfg. Co. v. Emmerson (1922) 258 U. S. 290 and Western Cartridge Co. v. Emmerson (1930) 281 U. S. 511, where under an allocation formula based upon property and business, interstate sales were attributable to the state of manufacture. From the language of the court in the Storen case it seems apparent that it would insist upon an allocation between the state of origin and the state of destination for it called attention to the fact that the tax if sustained could be imposed with equal right by the state of origin and the state of destination thus exposing the same gross receipts to double taxation.

Black in the *Storen* case. He protested the "unfair and discriminatory burden" which in his view was imposed by the court's decision upon those engaged in local commerce, and contrasted the cases upholding taxes nominally imposed upon a local subject or property but measured by gross receipts from interstate commerce. He reasoned that as congress had the exclusive power to regulate interstate commerce and, therefore, could protect such commerce from undue and unfair burdens, the court went beyond its province in invalidating a state tax because it might in some hypothetical future have resulted in multiple burdens on interstate commerce.

Puget Sound Stevedoring Co. v. *Tax Commission* [12] involved the validity of a Washington occupation tax measured by gross receipts, as applied to a domestic corporation engaged in a general stevedoring business but serving only vessels engaged exclusively in interstate and foreign commerce. The great mass of the taxpayer's business consisted of loading and unloading vessels by longshoremen working under the taxpayer's direction and control. In a few instances the taxpayer simply supplied longshoremen to shipowners without directing or controlling their work. Although the business here taxed was a "general stevedoring business," the court treated it as a business of two kinds.[13] The business of loading and unloading interstate and foreign vessels was held to be interstate and foreign commerce which the state could not "tax the privilege of doing by exacting in return therefor a percentage of the gross receipts." The business of supplying longshoremen to shipowners without directing or controlling their work was held to be a local business subject to a tax measured by gross receipts.

The decision invalidating the tax based on gross receipts from interstate commerce even though the business was of such a character that multi-state taxation was impossible [14] can be reconciled

[12] (1937) 58 Sup. Ct. 72.

[13] Compare Ficklen v. Shelby County Taxing District (1892) 145 U. S. 1, cited with approval in the Western Livestock v. Bureau of Revenue (1938) 58 Sup. Ct. 546. There a tax of $50.00 plus two and one-half percent of gross commissions was upheld as applied to merchants engaged in a general commission business, with the bulk of their commissions resulting from interstate sales. This case has been criticized and distinguished, but never overruled. See Brennan v. Titusville (1894) 153 U. S. 289; Crew Levick v. Pennsylvania (1917) 245 U. S. 292 and Stockard v. Morgan (1902) 185 U. S. 27. See also Raley and Bros. v. Richardson (1924) 264 U. S. 157, where a flat tax on commission merchants was held inapplicable to merchants doing wholly interstate business, but properly applicable to those doing both intrastate and interstate business. The court remarked that "one cannot avoid a tax upon a taxable business by also engaging in a non-taxable business."

[14] The gross receipts from loading and unloading interstate vessels would not be taxable by any other state nor does it seem that they would constitute the measure of a tax that might be imposed by the state of origin or destination of the cargo unloaded or loaded.

with the implications in the *Western Livestock* and *Storen* cases on the ground that the tax involved was a privilege tax. Thus the decision is in line with the cases like *Alpha Portland Cement Co.* v. *Massachusetts* [15] holding that a state may not exact a tax for the privilege of carrying on interstate commerce, a privilege which it does not grant, regardless of the measure.

Thus, legalistic reasoning is still employed to justify on the one hand, a tax even though cumulative burdens are possible provided the tax is called a privilege tax and is imposed upon a local privilege, and to invalidate on the other hand, taxes which are imposed upon the privilege of engaging in interstate commerce although there is no possibility of a cumulative burden on that commerce.

The Louisiana tax before the court in *Coverdale* v. *Arkansas Louisiana Pipe Line Company* [16] was not imposed upon gross receipts, but upon the privilege of producing power measured by the horse power of the "prime mover" or power-producing machine. In order to get natural gas to the pressure necessary to transport it through interstate pipe lines a company used compressors operated by engines. The court upheld a tax on the company for the privilege of producing power by these engines. It stated that the production of power was a local activity just as generation of electrical energy was in *Utah Power & Light Co.* v. *Pfost.*[17]

In this respect the case is striking in contrast with *Helson* v. *Kentucky*,[18] holding invalid a state tax as applied to the use of gasoline in operating a ferry boat running between two states. The *Helson* case and others were distinguished on the ground that they involved, in the words of the court, "taxes on interstate commerce and its instrumentalities rather than on operations closely connected with but distinct from that commerce." The tenuous nature of this distinction may indicate a reluctance on the part of the court to apply the rule of the *Helson* case. As in the *Western Livestock* case, the court was not content to dispose of the case solely on precedent but pointed out that the tax could be imposed by only one state, namely, the state in which the engines were located. It recognized that two states might tax the production of power, if engines connected with the same pipe line were located in several states, but stated that such multiple state taxation would result from "length of line, not interstate commerce."

Fourteenth Amendment

Concerned as the court has been in the recent cases just discussed to protect interstate commerce from the possibilities of multiple state taxation, it has shown no comparable anxiety over similar possibilities presented by the ad valorem taxation of intangibles.

[15] (1925) 268 U. S. 203.
[16] (1938) 58 Sup. Ct. 736.
[17] (1932) 286 U. S. 165.
[18] (1929) 279 U. S. 245.

The court, for example, in *Schuylkill Trust Co.* v. *Commonwealth of Pennsylvania*[19] sanctioned the ad valorem taxation of corporate shares held by a non-resident, even though the same stock might also be taxed in another state. In accord with previous decisions,[20] it also held that the state need not allow any exemption equivalent to the value of the shares attributable to the corporation's ownership of federal securities, other than national bank shares, so long as it did not discriminate against such securities in computing the tax base.[21] Relying on *Corry* v. *Baltimore*,[22] the court rejected the suggested distinction that in the instant case the act declaring the liability of the shares of non-residents, did not antedate the charter of the corporation nor provide that the situs of the shares should be in the state of the corporate domicile. It pointed out that for many years before the granting of the charter the state constitution contained a reserved right to alter and amend, so that every stockholder acquired his shares with full knowledge that they could be subjected to regulation and taxation. The court reasoned that as a share of stock represents an aliquot proportion of corporate assets[23] and depended on the law of the corporation's state of domicile for protection and preservation, it was within the taxing jurisdiction of that state, even though the ownership of the stock might also be a taxable subject in another state under the doctrine of *First Bank Corporation* v. *Minnesota*.[24]

The case apparently supports the proposition that nothing in the fourteenth amendment prohibits multiple ad valorem taxation of intangibles. While not over-ruling either *Farmers Loan & Trust Co.* v. *Minnesota*[25] or *First National Bank* v. *Maine*,[26] it strips those cases of implications respecting property taxation and limits them to the field of death taxation. The dictum of Mr. Justice Stone in *First Bank Stock Corp.* v. *Minnesota*,[27] that intangibles can have no location in space and that the fiction of *mobilia sequuntur personam* cannot be used to exempt an owner of intangibles from contribution to costs of government in return for benefits

[19] (1938) 58 Sup. Ct. 295.

[20] Van Allen v. Assessors (1866) 3 Wall. (70 U. S.) 573; National Bank v. Commonwealth (1869) 9 Wall. (76 U. S.) 353; Cleveland Trust Co. v. Lander (1902) 184 U. S. 111; Des Moines Nat. Bank v. Fairweather (1923) 263 U. S. 103.

[21] See the decision rendered on the previous appeal of this case (1935) 296 U. S. 113.

[22] (1905) 196 U. S. 466.

[23] Cf. Rhode Island Hospital Trust Co. v. Doughton (1926) 270 U. S. 69; see comment, (1927) 15 Calif. L. Rev. 248.

[24] (1937) 301 U. S. 234.

[25] (1930) 280 U. S. 204, A. L. R. 1000.

[26] (1932) 284 U. S. 312, 77 A. L. R. 1401.

[27] *Supra* note 24, at 241.

bestowed by a state, becomes the elegy of a doctrine long regarded as far-reaching in scope even after it had been excluded from income taxation in *Cohn* v. *Graves* [28] and *Whitney* v. *Graves*.[29]

The rule against multi-state taxation of intangibles is not inexorable even in the field of death taxation to which it is now restricted, as the well-known *Dorrance* litigation [30] graphically demonstrates. While domicile in legal theory exists in but one jurisdiction, it may in legal fact exist in several. A year ago the committee of the National Tax Association on double domicile in inheritance taxation looked for some solution of the dilemma in the settlement of certain cases then pending before the United States Supreme Court.[31] The court's recent decision in one of those cases, *Worcester County Trust Co.* v. *Riley*,[32] rejected a practical solution which would have made possible determination of the disputed fact of domicile by the independent federal judiciary.

The Federal Interpleader Act [33] gives the Federal District Court original jurisdiction in interpleader petitions " filed by any person . . . having . . . money or property . . . if two or more adverse claimants, citizens of different states are claiming to be entitled to such money or property." [34] The executor of a decedent attempted under this act to interplead the tax officials of Massachusetts and California, as both states were claiming death transfer taxes upon the transfer of the same intangibles.

The court held that the suit was in substance one against the state of California and hence forbidden by the eleventh amendment.[35] The court distinguished between suits against state officials enforcing unconstitutional state statutes, to which the federal judicial power extends notwithstanding the eleventh amendment,[36] and

[28] (1937) 300 U. S. 308.

[29] (1937) 299 U. S. 366.

[30] In re Dorrance's Estate (1932) 309 Pa. 151, 163 Atl. 303, cert. denied, Dorrance v. Pennsylvania (1932) 287 U. S. 660; In re Estate of Dorrance (1934) 115 N. J. Eq. 268, 170 Atl. 601, cert. denied (1936) 298 U. S. 678; New Jersey v. Pennsylvania (1933) 287 U. S. 580; Hill v. Martin (1935) 296 U. S. 393. Notes (1932) 81 Pa. L. Rev. 177; (1933) 18 Minn. L. Rev. 737; (1934) 34 Col. L. Rev. 1151.

[31] In addition to the Riley case the committee called attention to Texas v. New York et al., wherein the supreme court appointed a master to take testimony and report.

[32] (1937) 58 Sup. Ct. 185.

[33] Section 24 (26) of the Judicial Code as amended; 49 Stat. 1096 (28) U. S. C. A. sec. 41 (26).

[34] *Ibid.*

[35] " The judicial power . . . shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state."

[36] The court recognized that under Ex parte Young (1908) 209 U. S. 123, the eleventh amendment is no bar to a suit against a state official

suits against state officials, enforcing state statutes constitutional on their face which are in effect suits against "one of the United States" and beyond the federal judicial power. It pointed out that under the California statutes the tax would be imposed only if it were judicially determined that the decedent had been domiciled in California and it was not contended that the California officials were taxing independently of the judgment of a court.[37] Even if both Massachusetts and California courts had found the decedent domiciled in their respective states there would in the court's opinion have been no violation of due process as the fourteenth amendment does not protect against inconsistent or erroneous state court decisions.

Earlier in *First National Bank of Boston* v. *Maine*,[38] the court took the position that "intangibles constitutionally can be subjected to a death tax by one state only." [39] It has been forced to deviate from this position by the recognition that multiple state death transfer taxation of intangibles in the double domicile cases is beyond the reach of federal constitutional prohibitions.[40] The eventual solution may lie, as suggested in the third report of the committee of the National Tax Association,[41] in interstate compacts or reciprocal legislation between states.

The due process clause has been involved as well as the commerce clause in the cases turning on the distinction between a privilege fee and a tax. *Atlantic Refining Co.* v. *Virginia* [42] calls attention to the distinction between the two in their application to foreign corporations. The state exacted from a foreign corporation an entrance fee for the privilege of doing intrastate business, varying according to the authorized capital stock of the corporation but not to exceed $5,000 for corporations having an authorized capital of

acting without legal authority. This was not the situation in the instant case, where the state official's acts did not involve any breach of state law or of the United States Constitution.

[37] The fact that the state statutes did not impose death taxes on a non-domiciliary basis as they did in First National Bank v. Maine (1932) 284 U. S. 312, and Farmers Loan and Trust Co. v. Minn. (1930) 280 U. S. 204, cleared them of any unconstitutionality. The California Act afforded opportunity for a judicial determination of the question of domicile, so that at most there could be a conflict of court decisions only on the fact-question of domicile, a conflict not "forestalled" by the United States Constitution.

[38] (1932) 284 U. S. 312.

[39] *Ibid.* at 328.

[40] The court seems to recognize that double domicile cases result from conflicting decisions of the courts of different states "upon the same issues of fact," and that differences in proof and the latitude necessarily allowed to the trier of fact in each case to weigh and draw inferences from evidence and to pass upon the credibility of witnesses, might lead an appellate court to conclude that in none is the judgment erroneous." 58 Sup. Ct. at 188.

[41] (1938) Proceedings of the National Tax Association, p. 453.

[42] (1937) 58 Sup. Ct. 75. See comment (1938) 24 Va. L. Rev. 326.

more than $90,000,000. The appellant corporation paid the maximum fee. The court held it constitutional, relying on two previous decisions involving the constitutionality of the same statutes.[43] Its intervening decision in *Cudahy Packing Company* v. *Hinkle*,[44] however, made necessary an extended discussion of the reasons for distinguishing that case.

The court assumed at the outset that the doctrine of unconstitutional conditions might be invoked for conditions to be fulfilled wholly before admission.[45] It pointed out, however, that an entrance fee, as the sale price of the privilege of doing local business, constitutes a non-recurring charge, analogous to the charter or incorporation fee of a domestic corporation, which may be fixed in any manner the state sees fit to adopt. It went on to state that "even if the United States Constitution conferred upon every corporation the right to enter any state and carry on there a local business upon paying a reasonable fee, there is nothing in the record to show that the $5,000 charged is more than reasonable compensation for the privilege granted." As the amount of the fee bore no relation either to the volume of interstate business or the amount of property outside the state and was not arbitrarily fixed,[46] the fee was held not to violate either the commerce clause or the due process clause.

The same considerations with respect to the commerce and due process clauses were disregarded in *Cudahy Packing Co.* v. *Hinkle*,[47] but the court distinguished that case on the ground that there the corporation had previously entered the state with permission to do local business, and pursuant to that permission had acquired property and made expenditures. Whatever was imposed after the admission of the corporation was regarded by the court as a tax rather than a filing fee. The distinction is theoretical, for a filing fee measured by total authorized stock imposes the same literal "burden" as does a tax measured in the same manner. The burden in the *Atlantic Refining* case was legitimatized by being anticipated, while the burden in the *Cudahy* case, being a sequel rather than a prelude to admission, violated not only the commerce but the due process clause. The burden remained the same regardless of its

[43] General Ry. Signal Co. v. Virginia (1918) 246 U. S. 500; Western Gas Construction Co. v. Virginia (1928) 276 U. S. 597, affirming per curiam (1927) 147 Va. 235, 136 S. E. 646.

[44] (1929) 278 U. S. 460.

[45] See Western Union Tel. Co. v. Kansas (1910) 216 U. S. 1; Terral v. Burke Construction Co. (1922) 257 U. S. 529.

[46] The court pointed out that the value of the privilege was dependent upon the financial resources of the corporation, of which the authorized capital stock was some indication. *Cf.* Airway Electric Appliance Corp. v. Day (1924) 266 U. S. 71.

[47] (1929) 278 U. S. 460.

name, but its validity was materially affected by the time at which it was imposed. The court found no discrimination between appellant corporation and domestic corporations. Citing *Hanover Fire Insurance Co.* v. *Harding*,[48] it states that the appellant in any event could not invoke the equal protection clause as it had not yet been admitted to do business in the state.

The case of *Connecticut General Life Ins. Co.* v. *Johnson*[49] illustrates that the measure of an excise tax, as distinguished from an admission fee, must bear some integral relation to the activities carried on by a foreign corporation within the taxing state. California imposed a tax upon the gross premiums received by insurance companies on contracts entered into outside the state with other insurance companies authorized to do business in California, reinsuring the latter companies against loss on policies of life insurance executed by them in California. The state contended that the reinsurance transactions were so related to business carried on by the company in California as to be a part of it, and that in any event no injustice was done as the state could have exacted a tax from the original insurers instead of allowing them to deduct from the measure of their tax liability the amount of reinsurance premiums paid by them to companies authorized to do business in the state.[50] The court denied the validity of these contentions, pointing out that "the reinsurance involved no transactions or relationship between [the company] and those originally insured, and called for no act in California." The decisive factor was said to be the state's power to control the objects of the tax. Had the contracts of reinsurance involved any action in California, such as the settlement and adjustment of claims, the inclusion of the reinsurance premiums in the measure of the tax might have been valid.[51]

In *Breedlove* v. *Suttles*[52] the court sustained a Georgia Poll Tax[53] against the claim that it violated the fourteenth amendment in favoring persons under twenty-one years of age, over sixty years

[48] (1926) 272 U. S. 494, 49 A. L. R. 713.

[49] (1938) 58 Sup. Ct. 436. See comment (1938) 86 U. of Pa. L. Rev. 543, 554.

[50] Following the court's decision in the instant case the California Legislature proposed a constitutional amendment (to be voted upon by the people at the general election in November) under which the taxes on insurance companies will be measured by the gross premiums "other than premiums for reinsurance" received from business done within the state. As no deduction will be allowed for premiums paid for reinsurance in other companies, the net result will be to include in the measure of the tax premiums upon all direct writings with respect to California business regardless of reinsurance contracts.

[51] *Cf.* Palmetto Fire Insurance Company v. Connecticut (1926) 272 U. S. 295; Compania de Tabacos v. Collector (1927) 275 U. S. 87.

[52] (1937) 58 Sup. Ct. 205.

[53] Georgia Code 1933, sections 92-108.

of age and women not desiring to vote.[54] The fact that the state constitution made payment of poll taxes a prerequisite to voting,[55] and the fact that women desiring to vote are required to pay current taxes only,[56] were held not to constitute a violation of the nineteenth amendment. The court found a reasonable basis for the exemption accorded to the several classes, even implying that failure to classify might render the tax invalid.[57]

Hale v. *Iowa State Board of Assessment and Review*[58] added another page to the story of taxation of non-taxables. The case involved the application of the Iowa net income tax to interest from bonds declared by Iowa statutes to be exempt from all taxation. As these statutes had once been part and parcel of the ad valorem tax statutes, the Iowa court held that they exempted the bonds from property taxes only. It went on to hold that the income tax was not a property tax, and could, therefore, properly be applied to interest from bonds.

The supreme court, citing the division of authority in the state cases as to whether or not an income tax is a property tax,[59] and also citing its own decisions, including *New York ex rel. Cohn* v. *Graves*,[60] on the nature of net income taxes, held that there was nothing unreasonable in the decision of the Iowa court. It pointed out that as Iowa did not have income taxes when its ad valorem tax statutes were passed, the legislature could not have intended to include income taxes in the exemption.

[54] It was pointed out that the tax upon minors would in effect be upon the fathers liable for their support, and that men over sixty are normally relieved of numerous public duties. The exemption of women was justified as a recognition of the special burdens they bear. "Moreover," the court said, "Georgia poll taxes are laid to raise money for educational purposes, and it is the father's duty to provide for education of the children."

[55] There is nothing in the United States Constitution that would seem to prohibit the conditioning of the right to vote on the payment of taxes. The court approved of the condition as an aid to tax collection.

[56] As women could be exempt from the tax altogether, the requirement that women desirous of voting must pay current taxes makes for equality for voting purposes.

[57] In Salt Lake City v. Wilson, 46 Utah 60, 148 Pac. 1104, cited by the court, the hardships that would result from imposing a poll tax upon all inhabitants without classification, were recognized. The court in that case said that "the legislature must deviate to some extent from any such Procrustean standard of equality as this."

[58] (1938) 58 Sup. Ct. 102. See Comments (1938) 26 Geo. L. J. 485; (1938) 23 Iowa L. Rev. 273; (1938) 86 U. of Pa. L. Rev. 318; (1938) 24 Va. L. Rev. 332; (1938) 12 Tulane L. Rev. 422.

[59] See Brown, *Nature of the Income Tax* (1933) 17 Minn. L. Rev. 127; Traynor and Keesling, *The Scope and Nature of the California Income Tax* (1936) 24 Calif. L. Rev. 493.

[60] (1937) 300 U. S. 308.

The same point arose in *Adams Mfg. Co.* v. *Storen* [61] with respect to the Indiana gross income tax, and the tax was held valid on the authority of the *Hale* case. Here again the history of the statute lent conviction to the theory that its exemption provision was intended to cover only property taxes and such other taxes as were known when the statute was passed.

Impairment of Contracts Clause

Several attempts were made, all unsuccessful, to defeat state taxation by invoking the impairment of contracts clause of the constitution. In addition to the contention in the *Hale* case [62] that the state net income tax was a property tax and therefore not applicable to interest on exempt bonds, it was argued in that case that the statute exempting the bonds created a contract between bondholders and the state. On the assumption that a contract did exist, the court held that it did not extend to the interest on the bonds.[63]

In *New York Rapid Transit Corporation* v. *The City of New York*,[64] a tax on utilities of 3% of their gross receipts designated for relief purposes was protested by the plaintiff utility which operated rapid transit railroads in the city of New York under contract with the city. The contract provided for a five-cent fare, which could be increased only by a majority vote of the people, and for a pooling of the gross receipts from operation and a division between the utility and city after the deduction of specific items. The plaintiff challenged the validity of the tax on the grounds that it impaired the obligation of its contract with the city and violated its rights under the fourteenth amendment.

As the contract contained no express exemption from taxes of any kind, the court held that the tax did not impair the contract, citing the principle that any surrender of the taxing power must be made in clear and unmistakable language,[65] and vetoing the suggestion that the imposition of the tax violated the provision of the contract as to the allocation of revenue.

In discussing the relevance of the fourteenth amendment, the court, in line with its decisions at the previous term,[66] held that there need be no relationship between the taxpayer and the purpose for which the money was spent. *United States* v. *Butler*,[67] which

[61] (1938) 58 Sup. Ct. 913.

[62] *Supra*, note 54.

[63] It was decided that even if the state statute exempting bonds from taxation created a contract, the state court's determination that the contract was limited to property taxes was not unreasonable.

[64] (1938) 58 Sup. Ct. 721, petition for rehearing denied, 58 Sup. Ct. 939.

[65] 58 Sup. Ct. at 730.

[66] Carmichael v. Southern Coal and Coke Co. (1937) 301 U. S. 495; Cincinnati Soap Co. v. United States (1937) 301 U. S. 308.

[67] (1936) 297 U. S. 1.

held invalid the tax imposed under the Agricultural Adjustment Act, was distinguished on the ground that it was part of an unconstitutional scheme to regulate production through expenditures.

The Federal Income

TAXABLE INCOME

The supreme court in its last term added substantially to the case law on the meaning of income under the sixteenth amendment. *Helvering* v. *Gowran*,[68] perhaps the most important of these cases, removed much of the uncertainty left by the *Koshland* case[69] with respect to stock dividends. The court held that a preferred stock dividend, paid to a common stockholder of a corporation with preferred stock outstanding, was constitutionally taxable as income, on the ground that it sufficiently changed the proportionate interest of the common stockholder by giving him new rights to share in the profits, or assets on liquidation, if the corporation were unable to pay the preferred shareholders in full.[70] Congress had provided

[68] (1937) 58 Sup. Ct. 154. See comments, (1938) 38 Col. L. Rev. 363; (1938) 26 Geo. L. J. 500; (1938) 51 Harv. L. Rev. 744; (1938) 36 Mich. L. Rev. 673; (1938) 86 U. of Pa. L. Rev. 441. See also, Helvering v. Pfeiffer (1937) 58 Sup. Ct. 159. Helvering v. Gowran adds to the restrictions on Eisner v. Macomber (1920) 252 U. S. 189, which began with Rockefeller v. U. S. (1921) 257 U. S. 176, U. S. v. Phellis (1921) 257 U. S. 156, Cullinan v. Walker (1923) 262 U. S. 134, and Marr v. U. S. (1925) 268 U. S. 536. *Cf.* Weiss v. Stearn (1924) 265 U. S. 242. The next step was taken in Koshland v. Helvering (1936) 298 U. S. 441, where the taxpayer, taking her cue from the reorganization cases, asserted that when she received a common stock dividend on preferred shares she received a different proportionate interest in the corporation, which was income to her on receipt. In sustaining this contention, the court apparently scuttled the requirement, upon which Eisner v. Macomber was partly based, that a stockholder must receive some of the corporate assets before he can be taxed as having received income. The Koshland case did not decide, however, just how different the proportions must be before the receipt of the new interest could be income. The problem is clarified to some extent by the Gowran case.

[69] *Supra*, note 68.

[70] A preferred dividend on preferred stock would seem also to be a taxable dividend as it increases the preference to dividends and to share in the assets of liquidation which the preferred stockholder has over the common. If participating preferred shares are outstanding, a common stock dividend on common stock apparently constitutes income, as the common shareholders have acquired a greater right to share in the earnings after the minimum dividend is paid to the preferred shareholders. In these instances, there is actually some change in proportionate interest. No change would occur, however, if a preferred dividend were paid to common shareholders when no preferred shares were outstanding. The court in the Gowran case laid no emphasis on the existence of outstanding preferred shares, and in Helvering v. Pfeiffer, *supra*, note 68, disposed of on another issue, did not mention whether or not there were such outstanding stock. It may have considered the point immaterial and the dividend income even though other preferred shares were not outstanding.

that "a stock dividend shall not be subject to tax." The court, however, rejected the government's contention that this exemption was intended, in line with *Eisner* v. *Macomber*,[71] to exclude only those stock dividends which could not constitutionally be taxed, and held that it exempted all stock dividends from the tax. The taxpayer sold the stock dividend in the year received. The act established cost as the basis for the computation of gain or loss on the sale or exchange of property,[72] and as the cost of the preferred stock to the stockholder in this case was zero, the total proceeds were taxable.[73]

It has been suggested [74] that the statute does not distinguish between income which is taxable on receipt and that which is exempt on receipt by statute; that in either case, the cost being zero, the basis is likewise zero. Thus, under the amendment to Section 115f made in the Revenue Act of 1936 [75] it is possible that a stock dividend may be taxed as income on receipt and, on the authority of the *Gowran* case, the whole proceeds taxed on its sale. The question has also been raised whether items taxable in the year of receipt but which escaped taxation will require a basis other than cost.

With respect to stock dividends from 1932 to 1936, an answer may be found in Sec. 113 (b) (1) (D), first passed in 1932, which provides in part as follows: "Proper adjustment in respect of the property shall in all cases be made in the case of stock . . . for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax free or were applicable in reduction of basis. . . ." For the four years in question, the dividends were tax-free and, accord-

[71] *Supra*, note 68.

[72] Revenue Act of 1928, Secs. 111 (a), 113.

[73] In Koshland v. Helvering, *supra*, note 68, it was held that the act did not provide for splitting the basis of the original stock between it and the dividend stock, so that possibility had to be discarded. The circuit court of appeals thought that the rule applied in the case of tax-free legacies and gifts, where no basis was provided by statute, should be followed and concluded that the market value of the dividend on receipt became its basis. See U. S. Treas. Reg. 45 (1918) Art. 1562; Brewster v. Gage (1930) 280 U. S. 327. The act, however, now provides a basis in the case of bequests and gifts, so the analogy cannot be followed. Furthermore, it provides that the basis of property, except where specifically provided for, is cost (Revenue Act of 1928, Sec. 113). As the dividend cost nothing and had been income, it could constitutionally be given a zero basis. See (1938) 38 Col. L. Rev. 363, 368.

[74] (1938) 26 Calif. L. Rev. 388; (1938) 5 U. Chi. L. Rev. 512; (1938) 51 Harv. L. Rev. 744.

[75] "A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the sixteenth amendment to the constitution."

ingly, would reduce the basis of the stock on which the dividend was paid. A necessary implication of such a result is that the amount by which the original stock's basis is reduced should become the basis of the tax-free dividend. The purpose was to treat the dividend as a return of capital and hence to divide the original investment between the two forms by which it is now represented.

That does not answer the problem completely. Where the dividends are taxed on receipt, will they again be taxed? It must be conceded that there is no specific provision which will ascribe to these items a basis other than cost. The aim of the income tax acts, however, is to tax net gain, which would seem to preclude taxing the same income twice to the same recipient, once on receipt and again on redefinition. Gain once taxed should not thereafter be taxed.[76] It is probable that some such theory will find expression in an opinion if the issue is raised.[77] Where the item, for some reason other than statutory exemption escaped taxation in the year of receipt, the outcome is doubtful. Probably the rule of the *Gowran* case will be followed and the basis will be cost.

In another case, *Palmer* v. *Commissioner*,[78] rights distributed to stockholders to buy stock in another corporation were held not to be taxable dividends, even though they had considerable market value when received,[79] on the ground that the receipt of an option does not constitute income. The court quoted the statutory definition of dividend, emphasizing the necessity of a distribution of money or property which diminishes the corporation's net worth,[80]

[76] Commissioner v. Owens (1935, C. C. A. 10) 78 F. (2d) 768; Haag (1930) 19 B. T. A. 982; Ball (1932) 27 B. T. A. 388.

[77] See Treasury Decision 3052, 3 Cum. Bul. 38 (Aug. 4, 1920); ". . . A dividend, paid in stock of another corporation held as a part of the assets of the corporation paying the dividend, is income to the stockholder at the time the same is made available for distribution to the full amount of the then market value of such stock (Peabody v. Eisner, 247 U. S. 347); and if such stock be subsequently sold by the stockholder, the difference between its market value at date of receipt and the price for which it is sold is additional income or loss to him, as the case may be." See John H. Cook, B.T.A. Docket No. 77140 promulgated Sept. 29, 1938.

[78] (1937) 58 Sup. Ct. 67. See Comments (1938) 51 Harv. L. Rev. 515; (1938) 86 U. of Pa. L. Rev. 317; (1937) 47 Yale L. J. 139.

[79] On the cash receipts and disbursements basis a dividend becomes income on receipt. On the accrual basis it becomes income on the ex-dividend date. Sharp v. Commissioner (C. C. A. 2nd 1937) 91 F. (2d) 802, reversed on another point (1938) 58 Sup. Ct. 748.

[80] Although this is the "outgo" test of Eisner v. Macomber, it is not inconsistent with the Gowran case, as the former dealt with the nature of income under the sixteenth amendment while the latter deals with the statutory requirement for a dividend. Since 1936, Sec. 115 (f) has provided that stock dividends shall be excluded from taxable income only where they do not constitute income under the sixteenth amendment. This provision leaves no room for limiting their taxability by an interpretation of the definition of dividends found in Sec. 115 (a).

and held that the distribution of options to buy its assets was not a diminution of corporate net worth.[81] Apparently it regards an option as involving too many contingencies [82] to be considered property in the contemplation of the income tax law.[83] It held at the same time that income was not realized by the exchange of the option plus money for the stock, although the value of the property acquired exceeded the option price. The bargain purchase rule [84] did not apply in the instant case because the value of the stock and the option prices coinciding on the day the option was created, there was no intent to distribute earnings.

The case of *Heiner* v. *Mellon* [85] provides the first authoritative decision of the court on two problems concerning the nature of

[81] This holding seems to disregard the plain economic facts in cases where rights are issued to purchase property at less than its market value. In such cases there is in every practical sense a decrease in corporate net worth. The option price is the maximum amount at which the property subject to the option can be valued as property of the corporation, Helvering v. Salvage (1936) 297 U. S. 106; Wilson v. Bowers (1932) 57 F. (2d) 682; Lomb v. Sugden (C. C. A. 2d, 1936) 82 F. (2d) 166; (See (1936) 36 Ill. L. Rev. 537, 540, note 11), and the net worth is decreased by the difference between that price and the market value. Furthermore, the stockholder has received something of value, separated from his previous interest in the corporation, represented usually by certificates commonly dealt with on the exchange as is the stock acquired through them. If, however, these options were held to be property, a deductible capital loss would result upon their lapse. See Section 117 (e) (2) of the Revenue Act of 1936, Sec. 117 (g) (2) of the 1938 Act.

[82] See United States v. Safety Car Heating and Lighting Co. (1936) 297 U. S. 88.

[83] The court followed Helvering v. San Joaquin Fruit & Investment Co. (1936) 297 U. S. 496, holding that the value of an option owned on March 1, 1913, did not become capital of the taxpayer on that date. It also held that the option was not property, which when exercised, was "exchanged" together with the cash for real property, that the basis of the real property was not the March 1, 1913, value of the option plus the cash, and that income was not realized on the exercise of the option. Had the option been property, the taxpayer would have had income upon its exercise or exchange in an amount equal to the excess of the value of the land over the sum of the cash plus the March 1, 1913 value of the option. The holding in this case is thus inconsistent with any notion that an option is property or an asset, although in the course of its opinion the court said, "The option itself was property, and doubtless was valuable." See Merhengood Corporation v. Helvering (C. A. D. C. 1937) 89 F. (2d) 972, certiorari denied 58 Sup. Ct. 33, holding that an option to buy stock given as an inducement to enter a corporation's employ was not property constituting income on receipt or added to the basis of the stock when exercised. See also Bathwell v. Commissioner (C. C. A. 10th 1936) 77 F. (2d) 35, Rossheim v. Commissioner (C. C. A. 3rd 1937) 92 F.(2d) 247.

[84] Helvering v. Salvage, *supra*, note 81.

[85] (1938) 58 Sup. Ct. 926. This case also served to clarify certain problems of statutory interpretation in holding that the technical dissolution of a partnership upon the death of a partner does not affect the liability of the surviving partners for taxes on their distributive shares of the partnership

income. Two partnerships were formed under the law of Pennsylvania to liquidate the inventories of certain distilling companies. In 1920, both partnerships showed large profits from the sale of whisky, but Pennsylvania law forbade the distribution of any of these profits until the deceased partner's capital was returned. The court first decided that the partners had taxable income each year even though they had a liquidating business and could not therefore know for several years whether they would regain their capital and make profits. In holding that the basis should be apportioned among the cases of whisky and that the profit on the sale of each was income,[86] the court settled the doubts occasioned by the statement in *Burnet* v. *Logan*,[87] that the taxpayer "properly demanded a return of her capital investment before assessment of any taxable gain based on conjecture."

The court next decided that the partners were taxable on their distributive shares even though Pennsylvania law prohibited distribution of the profits. Such a tax is similar to taxing a shareholder on his proportionate part of the undistributed profits of the corporation.[88]

In another partnership case, *Guaranty Trust Co.* v. *Commissioner*,[89] the decedent's returns were filed on a calendar year basis, although the partnership of which he was a member reported on a fiscal year basis. The return for the decedent included his share of the partnership profits for the full fiscal year last ending. The executor objected, however, to the inclusion of partnership profits for the portion of its fiscal year closed by decedent's death on the ground that as income taxation is based on annual accounting periods income for two periods should not be included in one return.

income pending final liquidation and distribution. The court specifically denied the contention that because the partners' interests were capitalized upon dissolution, no taxable income resulted until the liquidation returned to the partners the cost of their interest.

A more formidable argument was made that under Pennsylvania laws the surviving partners became trustees for liquidation and that the income should therefore be taxed to them as trustees. The court, however, held that the local law was not controlling and that the term "trustees" as used in the revenue act did not include the taxpayers who under that act were more appropriately considered as partners carrying on business.

[86] See also Elmhurst Cemetery Co. v. Commissioner (1937) 300 U. S. 324; Morrissey v. Commissioner (1935) 296 U. S. 289.

[87] (1931) 283 U. S. 404. The taxpayer sold some stock for cash plus royalties from the operation of a mine. The commissioner estimated the yearly yield needed to restore the taxpayer's investment, and claimed that any excess yearly royalty was income from the sale of the stock. The court held that the taxpayer could not be held to realize income until her capital was restored.

[88] See Helvering v. National Grocery Co. (1938) 58 Sup. Ct. 932, discussed below.

[89] (1938) 58 Sup. Ct. 673.

He contended that section 182 (a) of the 1932 act supported this position in providing for the inclusion in a partner's return of partnership profits "for any taxable year of the partnership ending within his taxable year", which, he argued, meant "any *one* taxable year," thus excluding from taxation a portion of the partnership profits. The court found no congressional purpose to relieve business income from taxation in the year distributable to a partner and held that the partnership profits for both periods were properly includible in the decedent's final return. It pointed out that congress has never undertaken to limit the income taxable in any one year to that derived from the taxpayer's activities occurring in that or any other single year. It held that the purpose of Section 182 (a) was to make certain that the distributive share of the partnership income included in computing the net income of a partner "shall be based upon the income of the partnership" distributable during the partner's taxable year, even though an accounting period of the partnership may not be wholly within that year and that the profits accruing to decedent from the two partnership accountings were taxable in that year even though the accounting periods aggregated more than twelve months.

In 1934 the court held that subsection (a) of Section 115 of the Revenue Act of 1928, defining "dividend" for income tax purposes as "any distribution made by a corporation to its shareholders . . . out of earnings or profits accumulated after February 28, 1913," and subsection (b) providing that for income tax purposes all distributions are paid from "the most recently accumulated earnings or profits", when construed together, disclosed a legislative purpose that pre-1913 accumulations shall not be distributed "in such fashion as to permit profits accumulated after that date to escape taxation."[90] This construction was applied in *Foster* v. *U. S.*[91] to thwart an attempt to charge to post-1913 earnings amounts distributed in partial liquidation of the corporation's stock. The court held that the amounts so distributed were in no part from "the most recently accumulated earnings" but chargeable to capital, leaving the post-1913 accumulations intact.

Bogardus v. *Commissioner*[92] creates new uncertainties regarding the taxability of bonus payments to employees. Shareholders of corporation B, formerly shareholders of corporation A, without any obligation to do so, voted a bonus to former employees of A in recognition of their valuable and loyal services to A. Finding that the payments were made without consideration and to persons who

90 Helvering v. Canfield, Thorsen v. Helvering (1934) 291 U. S. 163.

91 (1938) 58 Sup. Ct. 424. See comment (1938) 4 U. of Pittsburgh L. Rev. 207.

92 (1937) 58 Sup. Ct. 61. See comments, (1938) 86 U. of Pa. L. Rev. 315; (1938) 22 Minn. L. Rev. 539, 575; (1938) 44 W. Va. L. Q. 151; (1938) 12 Tulane L. Rev. 473.

had never been employed by the disbursing corporation and (as the parties had stipulated) that the payments were not made or intended to be made for any services to that corporation, the court held that they were intended as gifts and not as compensation, the historic fact of past service simply being a reason for the gift.[93] The court's earlier holding, that if the intention is to compensate more completely for past service the payment is taxable income although made voluntarily and without a consideration,[94] is not repudiated. The court's reasoning, however, that a payment cannot be both gift and compensation and the inference that every payment which is in any aspect a gift is perforce not compensation makes the administrative determination of the category into which a bonus payment falls almost impossible to make. Nor is the test suggested by the dissenting Justices satisfactory. They view the question as one of fact, to be determined by the trial court, whether the payment is made to requite more completely for past services or is made to show good will, esteem or kindness to persons who have served but without thought to make a requital for service. Under this test there may be as many different interpretations as there are courts to find the facts. A statutory provision that payments made by reason of past service are compensation regardless of the intention with which made appears to be the most satisfactory solution.

In framing the Civil War Income Tax Act of 1864 and every revenue act from 1913 to 1938, congress has struggled with the problem of preventing the avoidance of taxes on shareholders through the accumulation of corporate surplus. The expedient of taxing corporate profits to the shareholders employed in the Act of 1864 was used in the Revenue Act of 1913 only if the corporation was formed or availed of for the purpose of preventing the imposition of surtaxes upon its shareholders. *Eisner* v. *Macomber*[95] cast doubt upon the validity of this provision and in 1921 the system was changed to a tax of 25% on the net income of corporations having the defined purpose. This method with various changes, particularly in rates, is found in all subsequent revenue acts.[96] The difficulty of proving the requisite purpose has rendered extremely difficult the application of the section. The surtax on personal holding companies imposed by the Revenue Act of 1934 and strengthened by the Revenue Act of 1937, avoids this difficulty with respect to corporations, the greater part of whose income is derived from investment sources, by eliminating the necessity of proving a purpose to avoid surtaxes.

[93] Justices Brandeis, Stone, Cardozo and Black, dissenting.

[94] Old Colony Trust Co. v. Commissioner (1929) 279 U. S. 716.

[95] (1920) 252 U. S. 189, by overruling Collector v. Hubbard (1871) 12 Wall. (79 U. S.) 1.

[96] See Section 102 of the Revenue Act of 1938.

The undistributed profits tax imposed by the Revenue Act of 1936 was perhaps the most complete and effective method of solving the problem. The emasculation of that tax in the Revenue Act of 1938 gives renewed significance to the tax on corporations formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders. The doubts as to the constitutionality of this tax that have existed since its inception were finally removed by the decision in *Helvering* v. *National Grocery Company*.[97] The court held: that the tax in no way limits the powers of the corporation conferred by state law to declare or withhold dividends but is merely imposed upon corporations using their powers to prevent imposition of surtaxes upon their shareholders; that the tax was not laid upon a state of mind but upon net income, the existence of the defined purpose being a condition precedent to liability; that the prescribed standard was not too vague; that the retroactive assessment involved was not objectionable and that an invalid delegation of power was not given the commissioner. In holding that the penal nature of the tax did not render it invalid on the grounds that the taxpayer, the sole owner of the business, could not by conducting it as a corporation prevent congress from laying on him individually the tax on the year's profits, and by referring to the various provisions in the revenue acts from 1913 through 1937, taxing shareholders with respect to corporate income, the court clearly indicates that it no longer considers the corporate entity a bar to the taxation of corporate income to the shareholders.

Corporate Reorganizations

In four cases the scope of the reorganization provisions was considerably limited. In two, *Groman* v. *Commissioner*[98] and *Helvering* v. *Bashford*,[99] these provisions were interpreted to apply only where the securities acquired by a transferor represent a "continuing interest" in the property transferred and not solely an interest in new or different property.[100]

[97] (1938) 58 Sup. Ct. 932.

[98] (1937) 58 Sup. Ct 108.

[99] (1938) 58 Sup. Ct. 307.

[100] This interpretation appeared in Courtland Specialty Co. v. Commissioner (C. C. A. 2d, 1932) 60 F. (2d) 937, as an implication of the term "reorganization". It was adopted as conclusive by the supreme court in Pinellas Ice & Cold Storage Co. v. Commissioner (1933) 287 U. S. 462, holding that short-term notes were equivalent to cash and not "securities", as they did not represent a continuing interest in the transferred assets. See Helvering v. Minnesota Tea Company (1935) 296 U. S. 378, where the acquisition of common stock of the transferee, John A. Nelson Co. v. Helvering (1935) 296 U. S. 374, where the acquisition of preferred stock of the transferee, and Helvering v. Watts (1935) 296 U. S. 387, where the acquisition of bonds of the transferee, supplied the continuing interest and made the transactions reorganizations rather than sales of assets.

In the *Groman* case A Company, pursuant to agreement with the shareholders of B Company, organized C Company to which it transferred cash and its preferred stock. The shareholders of B Company transferred their B Company stock to C Company in return for C Company's stock, A Company's stock, and cash. It was admitted that the acquisition of C Company stock was tax-free, as C Company was a party to a reorganization, and the issue was whether the acquisition of A Company's stock was tax-free for the same reason. A Company was not a party to a reorganization as defined in Section 112 (i) (2).[101] The court held that the definition of reorganization in Section 112 (i) (2) was not intended to be all inclusive. Under this definition, A Company was not a party to the reorganization "within the natural meaning of the term," but merely the "efficient agent" in promoting the reorganization. It had been contended that A Company was a party on the ground that the separate entity of C Company, a mere agent of A Company, should be disregarded. The court held that A Company stock received by the B Company shareholders represented an interest in new assets and not a continuing interest in the property transferred and was therefore "other property", giving rise to taxable gain. The test was based on the principle that "where, pursuant to a plan, the interest of the stockholders of a corporation continues to be definitely represented in substantial measure in a new or different one, then to the extent, but only to the extent, of that continuity of interest, the exchange is to be treated as one not giving rise to present gain or loss."

In *Helvering* v. *Bashford*[102] the court decided that a taxable gain arose on the sole ground that there had been no continuity of interest. A Company bought all the stock of B, C. and D corporations, which it transferred to a subsidiary, X Company. The stockholders of B, C and D received from A Company cash, stock of X Company and stock of A Company. A Company retained 57% of the common and all of the preferred in X Company, thus coming within the statutory definition of "a party to a reorganization."[103] The acquisition by A Company of the B, C and D

[101] Revenue Act of 1928. Section 112 (g) (2) of the 1938 act.

[102] *Supra,* note 99.

[103] Sec. 112 (i) (1) — "The term 'reorganization' means . . . (c) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders (shareholders) or both are in control of the corporation to which the assets are transferred . . ." Under this definition, a reorganization occurred when A Company transferred to X Company assets in the form of stock in three corporations and in return received all the preferred and a majority of the common shares of X Company.

Section 112 (i) (2) — "The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one

stock also constituted a reorganization to which under the statutory definition, A Company was likewise a party.[104] Despite the fact that A Company was therefore a party to two reorganizations, under the statutory language, the court held that because the shareholders of B, C and D acquired, by receipt of the A Company stock, only an interest in new assets (A Company's) and not a continuing interest in the transferred assets, the A Company stock was "other property" giving rise to taxable gain, and A Company was not therefore a party to a reorganization.

The court answered the contention that A Company was a party to a reorganization as expressly defined in the statute by holding that as the whole purpose of the reorganization plan was to transfer the assets of the three reorganized companies to X Company, the subsidiary of A Company, A Company's ownership of B, C and D was "transitory and without real substance," and unnecessary to the consummation of the plan. Accordingly, there were virtually no differences from the *Groman* case, and the rule of that case applied.[105]

In the two other recent corporate reorganization cases, *Minnesota Tea Co.* v. *Helvering*[106] and *U. S.* v. *Hendler*,[107] debts of the corporations were assumed by the shareholders and by the transferee corporation, respectively. The court held that the assumption of the obligations gave rise to income and as it was not distributed to the shareholders it was not exempted by Section 112 (d) (1) but was taxable under Section 112 (d) (2).

In reorganizations, gain realized on the receipt of securities is not taxed.[108] Gain realized on the receipt of money or property is taxed[109] unless, in the case of a corporation, it is distributed.[110] If it is distributed to shareholders, they will be taxed on it.[111] If the money or property is used to pay creditors, any gain the corporation realized on its receipts will never be taxed. Where the taxation of

corporation of stock or properties of another." Another provision in the same section defining reorganization as "including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of all other classes of stock of another corporation." Under these definitions when X Company acquired properties of A Company, both were parties to a reorganization.

104 Section 112 (i) (1) and (2), *supra* note 103.

105 Commissioner v. Kitselman (1937) 89 F.(2d) 458, cert. den. (1937) 58 Sup. Ct. 29, accord without reference, Commissioner v. Newberry Lumber and Chemical Co. (C. C. A. 6th, 1938) 94 F.(2d) 447 seem out of line with the continuity of interest theory.

106 (1938) 58 Sup. Ct. 393.

107 (1938) 58 Sup. Ct. 655.

108 Sec. 112 (b) (3) and (4).

109 Sec. 112 (c) (1), (d) (2).

110 Sec. 112 (d) (1).

111 Sec. 112 (c) (1) and (2).

a gain cannot be postponed or passed on, as in the instant cases, the gain should be taxed when realized.[112]

Depletion

The nature of a depletable interest in oil and gas wells was before the court in three cases. It had previously stated that a taxpayer had a depletable interest if he had an economic interest in the oil and gas.[113] The use of this test led to a great confusion as is evidenced by the reversal of the circuit court of appeals in each of the three cases. Its latest pronouncement that the taxpayer must have a "capital investment or interest" in the oil or gas in place and that a mere economic interest is insufficient will probably prove no less confusing.

In *Helvering* v. *Bankline Oil Company*[114] the taxpayer had a contract entitling him to possession of the oil at the well after it was pumped to the surface and the right to refine the oil and pay the owner of the well in kind. He was held not to have a depletable interest as he had merely a contractual right against the owner of the oil and no interest therein before it was pumped to the surface.

In *Helvering* v. *O'Donnell*,[115] a shareholder in a corporation owning oil wells and producing oil and gas was held not to possess any depletable interest. Accordingly, when all the shares were sold to another corporation and the taxpayer received for his share a portion of the net proceeds from the production of the oil wells, he did not have the required depletable interest as he acquired no greater interest in the oil and gas in place after the sale of his shares than he had before their sale.

In *Helvering* v. *Elbe Oil Land Development Company*,[116] the taxpayer had sold the property under an agreement entitling the purchaser to abandon the property at any time prior to the middle of the second year, the taxable year in question. The contract stated that the taxpayer retained no interest in the property although during these years there was the possibility of a reversion upon abandonment by the buyer. The purchaser, however, did not abandon the property. The court, ignoring the possible reversion, held that the taxpayer had retained an interest in the oil and the gas in the place, and therefore had no depletable interest.

In another depletion case, *Helvering* v. *Mountain Producer's Corporation*,[117] the taxpayer, an owner of oil leases, entered into a con-

[112] See, however, (1938) 38 Columbia L. Rev. 685; (1938) 24 Va. L. Rev. 203 and 418.

[113] Palmer v. Bender (1932) 287 U. S. 551.

[114] (1938) 58 Sup. Ct. 616.

[115] (1938) 58 Sup. Ct. 619.

[116] (1938) 58 Sup. Ct. 621.

[117] (1938) 58 Sup. Ct. 623. See Comment (1938) 16 Texas L. Rev. 601.

tract to sell all the oil produced. The purchaser agreed to conduct all the development and production operations and to pay cash royalties to the taxpayer. The taxpayer's contention that the development and production costs should be considered gross income for the purpose of computing the seller's depletion allowance, was rejected as too theoretical and contrary to the natural sense in which the term "gross income from property" was employed in the statute.

MISCELLANEOUS

Biddle v. *Commissioner*[118] held that no credit was permissible under Section 131 of the Federal Revenue Act of 1928, allowing a citizen of the United States a credit for income taxes paid to any foreign country, for the English standard tax on corporate dividends. The English tax is imposed on corporate earnings each year whether or not dividends are paid. If a dividend is paid, the tax is considered as part of the gross dividend. Each recipient of the dividend includes his pro rata share of the tax in his gross income for English super tax purposes, and if by reason of exemptions or deductions his net income is below a certain figure he can get a refund from the government of his pro rata share of the tax paid by the corporation. In England this system is considered as a payment of the tax by the shareholder. The court applying American rather than English tests in holding that the corporation and not the shareholder pays the English tax within the meaning of Section 131, reasoned that the English tax was similar to our corporate income tax and that as a shareholder in an American corporation receives no credit for the corporate tax neither should a shareholder in British corporations.

Although the Regulations[119] require claims for refund to state specifically the grounds on which based, claims are sometimes considered notwithstanding they are general. If a general claim is considered, it may be amended to set forth specific grounds even though the time for filing refund claims has elapsed.[120] If a specific claim is filed, it may be amended after the expiration of the statutory period if its effect is merely to set forth with greater particularity the grounds set forth in the original claim[121] but not if its effect is to set forth new and additional grounds for relief.[122]

[118] (1938) 58 Sup. Ct. 37. See comments (1938) 38 Col. L. Rev. 691; (1938) 23 Cornell L. Q. 329; (1938) 86 U. of Pa. L. Rev. 552. See also, Mitchell B. Carroll, International Double Taxation (1938) 16 The Tax Magazine 588.

[119] Reg. 94, Art. 322-323.

[120] U. S. v. Memphis Cotton Oil Co. (1933) 288 U. S. 62; U. S. v. Factors & Finance Co. (1933) 288 U. S. 89.

[121] Bemis Bros. Bag Co. v. U. S. (1933) 289 U. S. 28.

[122] U. S. v. Henry Prentiss & Co., Inc. (1933) 288 U. S. 73.

These rules were applied in *U. S.* v. *Andrews* [123] where the taxpayer was denied a right to amend his specific claim and in *U. S.* v. *Garbutt Oil Co.*,[124] where it was held that the untimeliness of the amendment was not waived by the commissioner's consideration of the merits of the position taken therein.

In two cases, *Pacific National Co.* v. *Welch* [125] and *U. S.* v. *Kaplan* [126] the court refused to permit taxpayers to change from the deferred payment basis to the installment basis after the time for filing returns had expired but before the expiration of the period of limitations for claiming refunds. The burdensome uncertainties in the administration of the revenue acts that would otherwise result seem clearly to justify making binding an election between methods of reporting income.

Acquittal of the defendant in a criminal action for "willful evasion of the revenue laws" was held in *Helvering* v. *Mitchell* [127] not to bar recovery of an assessment of the 50% addition to the deficiency due to fraud, provided in Section 293 of the Revenue Act of 1928. The court held that the addition was civil and not criminal in nature, and that its purpose was not to punish but to protect the revenue and to reimburse the government for the heavy expenses of the investigation and loss resulting from the taxpayers' fraud. As the burden of proof is greater in criminal than in civil cases, acquittal in a criminal case is not res judicata in the civil case even though the facts, issues and parties be the same, and as the case is civil no question of double jeopardy can arise.

In *Phillips-Jones Corporation* v. *Parmley*,[128] the right of the shareholder, held liable as a transferee in *Phillips* v. *Commissioner* [129] to contribution against other shareholders was upheld. The transferee's right to contribution arises from the general law and does not differ from that of any other person who has paid more than his fair share of a common burden. Accordingly, it was of no consequence that the commissioner had made no assessments against the other shareholders, or that the sections of the revenue act imposing transferee liability made no provision for contribution.

Section 607 of the Federal Revenue Act of 1928 provides that any payment of a tax after its collection is barred by limitation is an overpayment and section 609 provides that any credit against a barred liability is void. In *McEachern* v. *Rose* [130] the court was

123 (1938) 58 Sup. Ct. 315. See comment, 51 Harv. L. Rev. 935.
124 (1938) 58 Sup. Ct. 320.
125 (1938) 58 Sup. Ct. 857.
126 (1938) 58 Sup. Ct. 859.
127 (1938) 58 Supt. Ct. 630.
128 (1937) 58 Sup. Ct. 197. See comment (1938) 32 Ill. L. Rev. 756.
129 (1931) 283 U. S. 589.
130 (1937) 58 Sup. Ct. 84.

called upon to decide whether these provisions prevented the government from relying upon a barred deficiency of income tax for the year of death of a decedent to deny refund of overpayments made by the administrator of decedent's estate for subsequent years. The overpayments and deficiency, respectively, resulted from the error of the administrator in reporting as income for the years following death, gains from an installment sale which should have been included in income for the year of death. The court, applying the literal language of the statute, held the overpayments could not be credited against the barred deficiency and accordingly should be refunded. The case in itself is of little importance particularly since a different result will unquestionably be reached in similar situations under the provisions added by Section 820 of the Revenue Act of 1938 to mitigate the effect of the statute of limitations in cases of this character. It gains significance, however, when considered in relation to previous cases on recoupment.

In *Bull* v. *U. S.*[131] a taxpayer was permitted to apply an overpayment of estate tax, recovery of which was barred, against an income tax later imposed on the same item as that on which the estate tax was paid. The decision was based on the application of equitable principles to prevent the government from unjustly retaining two taxes on the same item. The *McEachern* case presents an almost exact converse situation and, admittedly, a contrary result would have been reached were it not for the specific provisions of sections 607 and 609. The court's refusal to permit the application of the overpayments against the barred deficiency must thus be accepted as a reversal or modification of the statement in *Stone* v. *White*,[132] decided at the previous term, to the effect that these sections of the act did not deprive the government of equitable defenses. The decisions in the two cases, however, are entirely consistent.

In the *McEachern* case, recovery of the overpayments could be prevented only by crediting them against the barred deficiency of the taxpayer for an earlier year, a procedure specifically prohibited by the statute. In *Stone* v. *White*, a different situation existed. The trustees of a trust sought to recover a tax paid by the trust on income which should have been taxed to the beneficiary. Since recovery by the trustees would inure to the benefit of the beneficiary and would result in income escaping taxation, inasmuch as collection from the beneficiary was barred, the government unquestionably had an equitable defense unless prohibited by Sections 607 and 609. Although collection from the beneficiary was barred at the time of payment by the trust, the trust was not paying the beneficiary's tax but was paying what it erroneously considered was its own, collection of which was not barred by limitation at the time of payment.

[132] (1937) 301 U. S. 532, 538.
[131] (1935) 295 U. S. 247.

Thus, the overpayment of tax by the trust existed independently of Section 607 and not by virtue of that section.

Section 609 likewise was not applicable. Although, equitably considered, a beneficiary and a trust may have identical interests, they are separate entities for income tax purposes. Since the only authority in the act for the crediting of overpayments [133] contemplates that the credit shall be applied against taxes due from the taxpayer, congress in providing in Section 609 that overpayments shall not be credited against barred liabilities must have had reference to cases where the barred tax and the overpayment both related to the same taxpayer and not to cases like that of *Stone* v. *White,* where the barred deficiency was owing from one taxpayer and the barred deficiency was made by another. Hence, although these sections deprive the government of equitable defenses in cases falling within their provisions, these sections, not being applicable in *Stone* v. *White,* did not preclude reliance on the equities presented therein.

In reaching its decision in *McEachern* v. *Rose,* the court had occasion to consider the actual time when an overpayment was credited against a deficiency. It concluded that since the credit or refund was allowed when the commissioner signed the schedule of overassessments that that was the time when the credit was made. In such cases the credit is merely a bookkeeping entry. In *United States* v. *Wurts,*[134] the court was required to decide if the date of allowance of the refund, i. e., the signing of the schedule of overassessments, was the date of the making of the refund so that the statute of limitations on recovery of an erroneous refund would start to run when the schedule was signed. The court held that a refund was not "made" at the time it was "allowed." The use of different terms implies a different meaning, and as the government could not sue to recover an erroneously made refund before it had sent the money to the taxpayer, the statute of limitations should not commence to run before the cause of action arose.

The Federal Estate Tax

Section 302 (c) of the Revenue Act of 1926 as amended by Joint Resolution of Congress of March 3, 1931, and Section 803 (a) of the Revenue Act of 1932, which included in the gross estate of a decedent property irrevocably transferred with a reservation of a life estate to the transferor,[135] was interpreted in *Hassett* v.

[133] Sec. 322 (a) Revenue Act of 1928.

[134] (1938) 58 Sup. Ct. 637.

[135] Adopted to close the loophole left by May v. Heiner (1930) 281 U. S. 238, and the per curiam decisions of March 2, 1931, relying thereon. Burnet v. Northern Trust Co. (1931) 283 U. S. 782; Morsman v. Burnet (1931) 283 U. S. 783; McCormick v. Burnet (1931) 283 U. S. 784.

Welch [136] to be prospective only in operation, and therefore inapplicable to transfers made prior to March 3, 1931. The constitutionality of its application to transfers made after that date was upheld in *Helvering* v. *Bullard* [137] on the grounds that the purpose of the legislation was to prevent avoidance of estate taxes and that "Congress having the right to classify gifts of different sorts, might impose a tax at one rate upon a gift without reservation of a life estate, and at another rate upon a gift with such reservation." [138]

These reasons were repudiated by the court in 1932 in *Heiner* v. *Donnan*,[139] holding invalid the conclusive presumption in Section 302 (c) of the Revenue Act of 1926 that gifts within two years of the donor's death were made in contemplation of death. The court's present recognition of congress's power to classify gifts inter vivos with transfers at death not only indicates that *Heiner* v. *Donnan* was wrongly decided but goes far in removing the doubts concerning the validity of proposals to integrate gift and estate taxes into one tax.[140]

Another instance of the special tax advantages given residents of community property states is found in *Lang* v. *Commissioner*,[141] in which only one-half of the proceeds of the decedent's policies of life insurance were held includible in the gross estate as the premiums had been paid with community funds.

Amounts paid to charitable institutions by an executor pursuant to binding promises of the decedent, where the only consideration was a stipulated application of the amount received, were held not deductible in *Taft* v. *Commissioner* [142] as "claims . . . incurred . . . for an adequate and full consideration in money or money's worth". As such amounts were not testamentary transfers of the decedent, they were held not deductible as transfers to charitable institutions.

FEDERAL EXCISE TAXES

In *White* v. *Aronson*,[143] the only federal excise tax case reviewed during the last term, it was held that jig-saw puzzles are not subject

[136] (1938) 58 Sup. Ct. 559.

[137] (1938) 58 Sup. Ct. 565.

[138] *Ibid.* at page 567.

[139] (1932) 285 U. S. 312. See also Schlesinger v. Wisconsin (1926) 270 U. S. 230.

[140] See George T. Altman, *Combining the Gift and Estate Taxes* (1938) 16 Tax Magazine 259.

[141] (1938) 58 Sup. Ct. 880.

[142] (1938) 58 Sup. Ct. 891.

[143] (1937) 58 Sup. Ct. 95. The court limited the language of the decision in Baltimore Talking Board Co. v. Miles (C. C. A. 1922) 280 Fed. 658, which held a ouija board a game, and distinguished Mills Novelty Co. v. U. S. (Ct. Cl. 1931) 50 F.(2d) 476, upholding the tax on a coin-operating gambling machine.

to tax as "games and parts of games" under Section 609 of the Revenue Act of 1932.

PRESIDENT LELAND: Copies of Professor Traynor's paper, you will recall, will be available at the registration desk as you leave.

The next part of the program deals with the work of tax scholars, would-be authors, real authors, and simply those who write. We have heard of the grist that the legislatures have turned out, we have heard of the work of the courts. Professor Roy G. Blakey, of the University of Minnesota, has undertaken the very tedious job of trying to look over the tax literature and tell us something about the product there during the last year. Mr. Blakey is known to most of us for his work in digesting the *Proceedings* and the *National Bulletins* of the Tax Association, and the job that he has undertaken on the literature of the last year is not unlike that which he did for the association a great many years ago.

It is with a great deal of pleasure that I present Mr. Blakey.

RECENT PUBLICATIONS IN PUBLIC FINANCE

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The increase in the amount of taxes levied in recent years, and the consequent increase in the burdens of paying taxes and in the difficulties of administering them, have undoubtedly resulted in much more discussion of taxes and in the publication of an increasing number of tax articles, pamphlets, and books. In fact, the number of such publications has become so great that I have found it impossible to examine all of them carefully.

Two or three months ago I received a request from President Leland to review for this conference the publications of the past year. At first, I thought I would review five or six of the best books; make brief comments on another dozen or so, and list the others that seemed important enough to mention, but I have found time to do little more than list those which appear to be most interesting and useful.[1]

I gave up the attempt to decide which are the five or six best books. Those involving economic and social policy interest me most, as I imagine they do most economists; but others dealing primarily with administration may be of more interest to the many tax administrators who are members of this conference. On the other hand, the legal treatises and handbooks may be of more interest to

[1] The appended lists of titles were compiled and examined with much assistance from Gladys C. Blakey and from my former graduate student, Professor Rolland F. Hatfield, now of St. Thomas College, St. Paul, Minnesota.

attorneys and accountants and other types of books may appeal most to others in attendance.

Of the books, pamphlets and articles published during the last year or two, there have been an unusual number dealing with the income tax, particularly with the corporation undistributed profits tax; many others relate to public expenditures, public relief and public debts and an unusual number deal with the estimation, size, and distribution of the national income. There has been much discussion also of federal, state and local interrelations in public finance and there have also been an unprecedented number of popular treatises—booklets, pamphlets and articles—explaining tax principles and problems to high school students, women's clubs and laymen generally. The number of handbooks for tax advisors, accountants, and attorneys is increasing rapidly and many of them are becoming more specialized. How many of them will survive the keen competition and become regular annuals and how they will affect the older annuals hitherto considered standard remains to be seen. Substantial treatises on state income taxes, sales taxes, and public school finance have been less in evidence recently than a few years ago.

In the few minutes at my disposal I shall have time for brief comments only on a few of the recent publications, but I have prepared for those of you desiring them, lists of other selected titles, some of which are accompanied by short characterizations. (Appended below.)

In The Twentieth Century Fund's *Facing the Tax Problem* and its companion volume, *Studies in Current Tax Problems,* prepared under the direction of Professors Carl Shoup, Roy Blough and Mabel Newcomer, are works of unusual merit for those wishing a careful and concise analysis of the principal current federal and state tax problems with recommendations for improvement. The authors and the committee were particularly courageous in making recommendations relative to nearly all of these problems. Most writers and committees evade or hedge more or less with respect to the difficult issues. On the whole, most of the recommendations seem to be sound although a good many readers will question the practicability of a few of them. Other volumes so well known that they hardly need mentioning are those by the National Industrial Conference Board on the cost of government, and the proceedings of various tax organizations such as the National Tax Association, the Tax Policy League, and others. Mention should be made also of the very useful monthly mimeographed publications of the Tax Policy League. Among the other works of a general character are an unusual number of popular treatises published recently. Of those included on the appended mimeographed list mention may be made of Coyle's which is very New Dealish and suggestive although many will not agree with it. Kendrick and Seaver's is more orthodox.

Lowe and Wright's on income and estate taxes as well as Winslow and Munro's on death taxes are much more specialized and utilitarian.

Of the books which go into the economic and social theory of taxes at greater length mention may be made of Colm and Lehmann's *Economic Consequences of Recent American Tax Policy* and Simons' *Personal Income Taxation.* The authors of the former are more or less steeped in the recent theories of business cycles, purchasing power, credit manipulation, and other means of social control and they view tax policies from these angles. They also bring a somewhat foreign point of view from which they examine American problems. From the title one might surmise that Simons' book is a much narrower treatment, but the reader will soon find that he is concerned with personal income taxation as a part of a much broader and deeper problem. The author "makes nine proposals which define the proximate conception of a taxation millennium" and he favors highly progressive personal income taxation as "the means of mitigating inequality" and of obviating regimentation and thus of perpetuating a reformed system of free enterprise and democratic government.

Other valuable contributions on the income tax which deal less with theory are those of Buehler and Kendrick on the undistributed profits tax. Buehler's is somewhat more comprehensive, but Kendrick's is more analytical and unique. Most of the recent publications relative to the income tax are handbooks designed primarily for the use of practitioners and advisers, particularly for lawyers and accountants making out returns for others. Several titles may be found in the appended list.

Somewhat related to the income tax are the unusual number of recent studies and estimates of the national income. In some cases these estimates have been broken down by states. Notable are the studies of Kuznets (National Bureau of Economic Research), Leven (Brookings Institution), Nathan (U. S. Department of Commerce), Bernstein and others (Social Security Board), Martin and Slaughter (National Industrial Conference Board), and Stine (agricultural income, U. S. Department of Agriculture). The proceedings of the National Income Conference should be included here also and perhaps a number of these studies of income should be classed as works of theory. Although these studies are not of taxation directly, they are fundamentally related to it and, in their extent and scope, represent a new and promising development.

Naturally more attention than usual has been paid recently to public debts. In this connection attention should be called to the study of the Twentieth Century Fund, to that of the Department of Commerce on *Long Term Debts* (by Donald C. Horton) and to the Proceedings of the New York Academy of Political Science (autumn, 1937 meeting). Dun & Bradstreet's *Resources and Debts*

of the Forty-eight States (1937) (by Edna Trull) is valuable for state facts.

Of the numerous valuable works on the difficult problem of inter-relations between federal, state, and local governments mention should be made of Miss Newcomer's *Central and Local Finance in Germany and England* and also of the studies by Carr, Key, Malone, Maxwell, and Woolf. There is no more important problem today nor one more difficult of solution and everyone will profit by reading these works.

Dr. George Steiner's Ph.D. thesis on *The Tax System and Industrial Development* is a more extensive study than that by Loeffler and Groves of a few years ago, though it follows somewhat the same lines. Unfortunately, Steiner's thesis has not as yet been published in full although summaries and extracts from it have been published in a pamphlet and later in an article in the *Bulletin* of the National Tax Association. The results are somewhat negative, but the monograph will be of assistance to those in nearly every state who are attempting to answer questions as to the effect of taxes and other factors on the migration of industry from one state to another.

The studies on state problems are too numerous to mention here, hence those interested are referred to the list of titles below. It is appropriate, however, to call attention to the unusual number of valuable special reports published by the New York State Tax Commission. It would be very helpful if other state tax commissions could follow the example of the New York commission in providing fellowships to serious-minded, qualified students of public finance to make special studies of their state and local problems. A number of other state tax commissions have done much more than the average in tax research and some have presented their reports in more attractive form than heretofore, among them the commissions of Illinois, Kansas, Kentucky, Massachusetts, Michigan, Oklahoma, Connecticut and Mississippi, and perhaps others that I have overlooked. But, on the other hand, it is regrettable that a number of state tax commissions are not maintaining the standards of research and publication that they once reached. While mentioning New York note should be made of the very unusual reports related directly and indirectly to taxation, issued this year by the New York State Constitutional Convention Committee. These cover problems of local as well as state taxation.

In addition to some already mentioned in other connections, there are a large number of valuable studies relating to local finance on the appended list, far too many to mention here, although special attention should be called to the studies of Carr, Oakes, the National Association of Assessing Officers, and others of the Chicago group of associations dealing with public administration.

In preparing this review, requests for titles of all important publications were sent to all state tax commissions and also to all important American publishers of tax works; however, practically all routine and some less important official publications have been omitted from those commented on or listed, not because they are unimportant, but because space is limited and most of these are well known and relatively accessible. Numerous state and other special reports are included, though doubtless some have been overlooked or not received. At first I was tempted to include in this review such important 1936 books as Magill's *Taxable Income,* Stamp's *Fundamental Principles,* the public finance texts of Lutz, Buehler, and Antonio de Viti de Marco (translation by Edith Pavlo Marget), and others, but the limits of time and space necessitated omitting all works published before 1937.

On the other hand, I had, at first, intended confining my attention to books, but found some of the most interesting and helpful discussions in articles, hence I requested my assistants to compile selected lists of pamphlets and of articles in periodicals, though most of these are more ephemeral than the books and I have not undertaken to comment on many of them.

A number of members have asked when we are going to bring the National Tax Association *Digest and Index* up to date. We are hoping that we shall be able to do so before long if the association desires it done and will provide for publishing it. I should like to suggest that the association publish an annual bibliography such as this should have been, either in the annual *Proceedings* or as one number of the *Bulletin* or otherwise. If the association has the funds or can raise them through one of the foundations or otherwise, I should like very much to see it or someone else prepare a comprehensive bibliography on public finance. The best one in English now in existence, I believe, is that published by the Japanese. We are very much in need of a comprehensive American bibliography, one that would contain all important American titles and if possible, foreign titles also. This would be a very large undertaking although I think it would be justified and if supplemented by annual bibliographies such as I have suggested, would be of even greater usefulness.

Public Finance

Selected List of Recent Publications

BOOKS

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BOOKS

General and Miscellaneous Works

Bonbright, Prof. J. C. *The Valuation of Property.* McGraw-Hill, New York, 1937. 2 vols. $12.00. This work is concerned with the concepts of value, methods of valuation for rate making and for taxation and valuation for specific legal purposes. Tax valuations are discussed chiefly in the second volume, in chapters dealing with estate, inheritance, income and capital stock taxes.

Colm, Gerhard and Lehmann, Fritz. *Economic Consequences of Recent American Tax Policy.* Social Research, New York, 1937. 108 pp. $1.00. Consideration of the relationships between taxation and the business cycle.

Jensen, Jens P. *Government Finance.* Thomas Y. Crowell Co., N. Y., 1937. 595 pp. $3.50. Good orthodox text for the most part. Facts up to date; analysis might be more adequate.

——— *Public Finance, Taxation, and Tariff.* Crowell Co., New York, 1937. 595 pp. $3.50.

National Industrial Conference Board. *Cost of Government in the U. S. 1935-37.* N. Y., 1938. 163 pp. $3.50.

N. Y. State Constitutional Convention Committee. *Problems relating to the Bill of Rights and General Welfare.* Vol. VI. Albany, 1938. 685 pp.

Shoup, Carl and others, directors of research. *Facing the Tax Problem.* Twentieth Century Fund, N. Y., 1937. 606 pp. An excesselnt survey of current tax problems, with recommendations for meeting them. The latter are suggestive and valuable, though a few are impracticable.

——— *Studies in Current Tax Problems.* Twentieth Century Fund, N. Y., 1937. 303 pp. $3.50. Studies of six special subjects made preliminary to writing the volume on *Facing the Tax Problem.*

Schultz, Wm. J. and Caine, M. R. *Financial Development of the United States.* Prentice-Hall, Inc., N. Y., 1937. 757 pp. $5.00.

Steiner, H. Arthur. *Significant Supreme Court Decisions 1934-1937.* John Wiley and Sons, Inc., N. Y., 1938. 91 pp. $1.00. Sec. Ed.

Tax Policy League. *How Shall Business Be Taxed?* New York, 1937. 175 pp. $2.50. Symposium conducted by the Tax Policy League.

Tax Research Foundation. *Tax Systems of the World.* Commerce Clearing House, Chicago, 1938. 415 pp. An unusually extensive and useful tabulation of state and national (including foreign) tax laws and levies.

Popular Treatises

Coyle, David Cushman. *Why Pay Taxes?* National Home Library Foundation, Washington, 1937. 182 pp. 25c. Very New Dealish.

Kendrick, M. S. and Seaver, C. H. *Taxes: Benefit and Burden.* Newson, N. Y., 1937. $1.00. Adapted for use of senior high-school students.

Lee, M. G. *The Government's Hand in Business.* Baker, Voorhis and Co., New York, 1937. 451 pp. $5.00.

Lemke, W. *You and Your Money.* Dorrance, N. Y., 1937. $1.00.

Lowe, J. B. and Wright, J. D. *Minimizing Taxes on Incomes and Estates.* Barron's Pub. Co., N. Y., 1937. 100 pp. $2.00. Relatively simple exposition of methods an individual may use to minimize his taxes.

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PRESIDENT LELAND: We are greatly indebted to Professor Blakey for his review of this literature. I might say that what the program committee had in mind when they asked him to do this job was that it might be made permanent, having realized the importance of the very work that he is doing. I think Professor Blakey has found a job for himself now for sometime to come, if and only if there is enough interest on the part of the membership to warrant its continuance. We tried this purely as an experiment so that the review of the literature would fill a gap which is left by our judicial and legislative reviews, and in the course of time it seems to me that this work can take its place alongside of the others and become quite important so far as the advancement of knowledge in the field is concerned.

I agree with the suggestions that Professor Blakey has made, and I hope that we can find some way to carry them out.

This session is now open for general discussion, and the only limits on the discussion are the usual limitations on the time.

CHARLES W. GERSTENBERG (New York): Mr. Chairman, when Professor Blakey was making his announcement I was reminded that I think there is a statement in the Bible that, "Of the making of many books there is no end, and much study is a weariness of the flesh."

I should like to save some of that weariness if Professor Blakey could continue this study, and if it were in order I would make a motion now that the executive committee consider continuing this as a regular feature.

I think we are very much indebted to all of the speakers this morning for one very important change that has been made over past years, and that is the supplying of their speeches so that we may get the proceedings before the first of January. I presume it is all a part of a movement to speed up the reporting of our proceedings.

I was hopeful, however, that we might go even one step further. Professor Blakey's paper undoubtedly is an informational paper, and so was Mr. Manning's. Those call for little discussion. But it seems to me that if we could have had Professor Traynor's paper about a week in advance and then turned this meeting into a panel, most of us wouldn't have felt as addle-pated as I felt this morning.

I came across one case that he expounded and at that moment I was through with the rest of his paper. My mind kept going around and around with the statement that was made about that particular case.

I should like very much to ask Professor Traynor one question, and perhaps it will open up a line of discussion that some of the taxpaying people will care to pursue this morning.

I haven't read this case. It is the Worcester case. I have heard it referred to before. What is the full name?

MR. TRAYNOR: Worcester County Trust Company against Reilly.

MR. GERSTENBERG: You remember it is the case that involves the interpleader action. I sometimes wake up in the middle of the night and think of myself as the executor of the estate of Dorrance, and wonder what I would think, do, or undertake to do if I were the executor who has to pay, I think, something like $17,000,000 in one state and $14,000,000 in another. It is extravagant, perfectly extravagant. We felt, I think, that the interpleader action might be the way out.

Now I understand from the little that was said this morning in regard to this Worcester case that there was not a constitutional question involved. I would like to ask Professor Traynor this: could that action have been so framed by the estate that they could have brought the old question before the court? As I remember it, you cannot sue a state; you can sue an officer of a state on the theory that he, in doing an unconstitutional act, is stepping outside of his office, for he has sworn to obey the constitution, and when he undertakes to do an unconstitutional act, he theoretically steps outside of his office, and you bring an action against him to prevent him from going forward in his personal capacity in doing an unconstitutional act.

Was it not possible, perhaps, in the case, or would it not be possible in a similar case, to bring in the theory of due process? Say that, for example, in this particular case, the California officer in trying to collect the tax was trying to collect a tax on property outside of the jurisdiction and in trying to collect property tax on property outside of the jurisdiction, he was committing an unconstitutional act. Then, perhaps, the interpleader statute might have been properly invoked.

What do you think of that, Professor Traynor?

MR. TRAYNOR: Well, the very argument that you made was presented in this case, and the cases to which you refer, that state officials acting under an unconstitutional statute can be enjoined. This case was distinguished on the ground that here the tax officials of California were not purporting to act under an unconstitutional statute; in other words, they attempted to tax regardless of domicile.

Under the California statute the tax applied only if the testator were domiciled in the state, and under the California statute it took a judicial determination that the testator was domiciled in the state before the tax applied.

So that the court held that Ex Parte Young and cases like that to which he refers could have no application because there was no unconstitutional statute. The statute was constitutional on its face.

As to the due process point, as a matter of legal theory, Mr. Gerstenberg is correct. One can be domiciled in only one state, but when you get a court deciding that a person is domiciled in a

particular state, and then another court deciding that that same person is domiciled in its jurisdiction, then the error which you have is an error of the courts, and the due process of law clause doesn't protect against erroneous judicial decisions. You are in an impasse.

HENRY F. LONG (Massachusetts): Mr. President, to carry out this discussion a bit further, in order to get into what might be called the practical side, I recall at a very early day that Professor Gerstenberg held with Lord Beaconsfield, that a practical man was one who practiced the mistakes of his ancestors. I am going to follow that suggestion here, and in this Hunt case call to attention the difficulties which arose, and also so that we may start our meeting, knowing that all tax administrators are extremely merciful and kindly toward the taxpayer.

Hunt had not lived in the United States, in the sense of living, for a long while. He was a representative of the Standard Oil Company in Asiatic lands, but had maintained Worcester as his domicile, filing his federal income tax returns from there, and had kept his accumulated fortune in the Worcester County Trust Company, but prior to his death had lived in the neighborhood of Los Angeles where his sister had been for about a ten-year period and had built a house.

At the time of his death he had in Massachusetts sufficient money to take care of the tax which Massachusetts would lay against him, approximately $125,000, and, strangely enough, by some peculiar quirk, he had transferred to a Los Angeles bank about $145,000 in money which was sufficient to take care of the $130,000 tax to be levied by the state of California if he was domiciled there.

Mr. Hunt had consistently held Worcester as his domicile, although now that the case is over it can be told, he had no place of residence there in the sense of a roof over his head, but Massachusetts could, because the executor was willing, have held Massachusetts as his domicile, and we could have collected the 120-odd thousand dollars, because the money was there sufficient in volume —in fact, some two million and a half of securities which we could have taken. But we felt kindly toward California, and the California court, as Professor Traynor has said, through a different procedure than Massachusetts holds, a judicial procedure, had declared him domiciled there.

I think it stands to the everlasting credit of the California tax officials and the Massachusetts tax officials that both of us didn't go forward, as we unquestionably could, and declare Mr. Hunt domiciled in both states. Of course, there was a good deal of temptation to do that, because the immediate beneficiaries of Mr. Hunt were quite remote, and we wouldn't have been hurting anybody very seriously if each of us had taken it as if he had been domiciled in both states.

Pennsylvania and New Jersey, supposedly places of great virtue, have already laid the course for tax administrators in the Dorrance case by New Jersey remaining more or less silent, and after the court had said he was domiciled in Pennsylvania, siding with the estate and saying, "Yes, he must have been in New Jersey," and New Jersey, moreover, has followed it in several other cases.

Massachusetts undertook to settle with California before this case went up, but unfortunately California does not have, or did not have at that time, the provision for a compromise. Since that time, the legislature of California has seen the wisdom of giving its administrator some implementation so that he could compromise cases of this character, and subsequent deaths may not involve this difficulty.

But we did, both California and Massachusetts—perhaps California a little bit reluctantly, because I am looking to California right now; and Massachusetts with a good deal of care—join with the executor to find out in this case, they being the referee, if we couldn't use the interpleader act, and, much to our discomfiture, it resulted in the interpleader act being denied.

But to go further and make the final suggestion as to what merciful people the tax administrators are, despite the fact that there was no great opportunity at the beginning, Massachusetts and California did finally compromise this tax, so that it was settled.

Strangely enough, so that those of you who are practicing attorneys may sense the possibilities of the future, the California law which permitted the tax administrator there to engage an attorney outside the state, who happened to be a Massachusetts attorney, could not, as we understand the law, pay him anything on his fee except out of the winnings from the tax which were payable to the state of California. So the Boston attorney who had taken this case took it with a good deal of chance.

There, again, the tax administrator of Massachusetts was particularly merciful, because he sensed that at least the Boston attorney ought to have a fee. So in the settlement of the case with California, we made the arrangement that California should pay this Boston attorney his competent fee.

I simply offer that as an indication, at the beginning of this conference, of what merciful people we tax administrators are. (Laughter and applause).

President Leland: I think the lawyers particularly ought to congratulate Mr. Long.

Are there any other questions?

Henry Rottschaeffer (Minnesota): This is not in answer to the problem raised by Mr. Traynor or Mr. Gerstenberg, but it seems to me we might start out with an analogy suggested by the way the supreme court treats the matter of the existence of a

contract in the application of the contract clause to state legislative action.

In a case of that kind, the supreme court of the United States has taken the position that the question of whether a contract exists, and also that of what the contract is, is itself a question of constitutional law. On those matters, they will, if necessary, substitute their own ideas for those of the state court, even.

If we start with that as a point of departure, here you have this due process clause of the fourteenth amendment, saying that no state should tax unless it has jurisdiction to tax. In a case involving state inheritance tax, the question of jurisdiction is inseparably intertwined with the problem of the domicile of the decedent. If we should say that the question of domicile thereby itself becomes a subspecies of constitutional question, why, then, should not the supreme court take the position that an erroneous decision on the question of domicile itself raises a constitutional question?

I recognize that in the case of domicile the conclusion that domicile does not exist is an inference of law, but of course it is based on a record of certain facts. Equally so is the question, not so much of the existence of the contract, as the question of what the contract means. That, too, is ultimately an inference of law, as we lawyers talk about it. Nevertheless, it depends upon this illusive thing called the intention of the parties, which is a question, ultimately, of fact; but it comes up in the guise of what the lawyers call a question of law.

If the supreme court has been willing to treat the existence of the contract and its meanings as it has, the question is—which they in enforcing the constitution are required to determine, which they themselves have got to determine on their own initiative—why couldn't they do that with the issue of domicile in these tax cases?

That doesn't go to the question, of course, as to how, whether that question shall be brought before them through the proceedings involved in the Worcester Trust Company case, which were proceedings in the nature of a bill of interpleader, but it does suggest the theory along which they might ultimately work out a review of that particular issue on the basis of the record made in the particular case.

MR. TRAYNOR: I think that is a very constructive suggestion, and one I should like to see the court follow. I am afraid that some of the language used in this Worcester case might be discouraged in that respect, the language referring to the fact that the due process of law clause is no protection against erroneous decisions. The courts may be unwilling, because of the difficult questions of fact involved, to pass upon the complicated question of fact itself, simply on the basis of the record.

There is another case pending in the supreme court on this subject, in which the supreme court appointed a referee to take testi-

mony in the Hetty Green case, or a relative of Hetty Green's. I think Texas and a number of states are claiming him as being domiciled there. No final conclusion has been reached as to that. The report by Mr. Flannery, the referee, has, so far as I know, not yet been filed.

I have misgivings about that, and it seems to me that there is a way open, possibly, under Mr. Rottschaeffer's suggestion. It is one which I myself would prefer to see the court take.

MR. ROTTSCHAEFFER: Mr. Chairman, may I interpose just one further remark? Mr. Traynor is quite right. The supreme court has frequently said that due process clause of the fourteenth amendment does not protect one against an erroneous decision by a state court, but in every one of those cases, if my recollection be not amiss, the point with which the erroneous decision was concerned was a matter of state law. But clearly, if a state court makes an erroneous decision on a matter of federal constitutional law, it is reviewable by one or the other methods, and if on my theory, the erroneous decision on domicile becomes an erroneous decision on a matter of federal constitutional law, those cases that have said that due process does not protect against an erroneous decision by a state court would not, in my opinion, be in point.

PRESIDENT LELAND: Are there any other questions?

I am wondering if somebody wouldn't like to ask these gentlemen what is wrong with double domicile and double taxation anyway? It seems to me as if they have started out to do a lot of wishful thinking here about what tax policy ought to be, and they assumed the right answer to start with. I wonder if someone wouldn't like to raise that question?

THOMAS C. LAVERY (Ohio): I think the Green case answers that objection. As I understand it, there are four states claiming to be entitled to collect the taxes, and if they all make their claims stick under the Worcester decision, there won't be enough money to go around, and then you will have a civil war breaking out again.

MR. LONG: Mr. President, I would like to add to that because Massachusetts hopes to win the Green case. I think Professor Traynor, that the master is filing his report this week. It has been in the hands of the printer for about four days, and perhaps I will get a telegram today saying that the master's findings are in entire accord with what Massachusetts requested as findings.

But I did want to suggest, in extension to what Professor Lavery has said, that the United States Supreme Court practically denied Texas, Florida, New York and Massachusetts from being considered, unless we could show that the amount of taxes would be in excess of the estate. In that particular case, we would have been very willing to do as you suggest, namely, have him docimiled in

each state, but, unfortunately, the estate netted only $38,000,000, and the total tax of the four states was $41,000,000, and we didn't know where we could get the extra $3,000,000, but we were willing to split the 38,000,000 provided they were willing to let us split 25 per cent each of four ways.

We would have been willing to do that, but, unfortunately, the sister who was the recipient of the brother's estate was not willing for us to divide up all the fortune ourselves, because she had gone to some little expense herself in the administration of the estate.

President Leland: Are there any other questions on the papers?

Mr. Long: I would like just one moment, Mr. President. I think if I understand Mr. Rottschaeffer, stripped down to simple language, what I understand him to say is this: that while domicile is a fact, and the determination of domicile must depend upon fact—illusive, as he calls it, as to the determination of what was in the mind of the decedent, as I understand him—if the court holds as a fact that this man was domiciled in the state, and then holding—supposing there were two states holding—takes property, then he says that is a federal question, because it takes property without due process of law, and therefore we could raise that question in the federal courts.

I understand that is what you say.

George F. Gage (Minnesota): It seems to me that this question of domicile has been quite fully settled by the gentleman from California and the gentleman from Massachusetts. It all depends on the conscience of the lawyers. These two fellows seem to be the conscientious lawyers who really settled the case.

It is a question of presenting the facts, and if the lawyer doesn't have as much conscience as he might, his conscience can be guided by the large tax that is involved. Until you have really conscience-stricken lawyers like these two men you are going to have more or less trouble with domicile.

Mr. Rottschaeffer: Apropos of Mr. Long's statement, I didn't say domicile was a question of fact. I said it was an inference of law from a fact. The law is slightly different.

David Stock (New York): It is my recollection that several years ago the supreme court of the United States entertained jurisdiction in a case involving the question of where a murder was committed. Of course, that may not be such a far-fetched analogy, comparing murder with some of these estate taxes. The question there was purely a factual one as to where the murder had been committed. The court did pass on that question, which would seem to bear out Mr. Rottschaefer's approach.

Mr. Long: That was the murder of Smutty Nose, between Maine and New Hampshire. There a question of jurisdiction as to where

the land actually was, and whether or not the persons died there, was the point; or whether they died at the point to which the person who killed them had dragged them.

MR. STOCK: That was still a factual question.

MR. LONG:If it is a domicile question, we can't drag it from one state to another, much as we would like to.

PRESIDENT LELAND: Why can't a man in this day and age have two domiciles? You go back to your tradition, politically, people were supposed to live in one spot and vote in one place. Now they have residences in winter, residences in summer; part of their incomes and estates arise in one place and part in another; and you attempt to disfranchise them from local and state participation. If you would only limit them to voting once for the president of the United States and let them have two domiciles, why, as a political conception, isn't double domicile conformable to the realities of the situation and the court really may be right there in making this a policy matter rather than a matter of jurisdiction determination?

MR. LONG: Inasmuch as you and I as tax administrators have this in mind, unless the states can get the single domicile, so that there won't be an exhaustion of the estate by taxes, I am afraid you and I as tax administrators will see our inheritance tax diminished by the federal government taking over these questions where there is domicile, so we have to tread with a good deal of caution on your suggestion that we may be taxed in more than one state.

FRANCIS B. ELWELL (New Jersey): I was interested in what Mr. Long said about the very kindly attitude that he took in the California case. He also mentioned the Dorrance case. As it happens, I live in the county that benefited by New Jersey collecting from the Dorrance estate.

I would like to ask Mr. Long if he believes that Massachusetts would have felt as kindly if instead of $125,000 it had been $14,000,000, $15,000,000 or $16,000,000 involved?

MR. LONG: The answer is very simple. Massachusetts would have made a compromise with Pennsylvania. If any of you here can think of an estate the size of Dorrance's where they might want to live in Massachusetts part of the time and in New Jersey part of the time, I will assure you now that we will make a fifty-fifty split with New Jersey so there won't be but one tax on the estate.

MARTIN SAXE (New York): It may be of interest while we are on this subject to point out that in a tax article for the constitution adopted at the constitutional convention in New York this year there is a provision with respect to the taxation of intangibles at the domicile of the owner. That is to say, the *situs* for the taxa-

tion of intangibles shall be that of the owner, and in the case of death taxation, New York will not exact any tax unless there is no state that can impose a death tax.

Whether that will be adopted by the people remains to be seen at the coming election.

MR. LONG: Is that one of the non-controversial subjects?

MR. SAXE: Article 1 in the so-called non-controversial subjects.

PRESIDENT LELAND: Are there any other questions someone else wants to raise? This just seems to be opened up right now.

HARLEY L. LUTZ (New Jersey): There was a point in your last statement which, it seemed to me, passed over the audience. You were suggesting that it is possible for a person to have more than one domicile, and out of that you imply it is possible for him to vote in more than one place. I suggest that there is a case in which the practice has run far ahead of the law. I think we ought to do something about our election laws so as to recognize the facts as they are, those facts being that a great many people do vote in more than one place, sometimes vote in the same place more than once.

If we are going to get this matter of domicile, voting privileges and franchises straightened out, we might just as well bring the law up to date, because I think I am disclosing no secret when I say that in New Jersey we do vote them in as many places and as many times as may be necessary in order to get the count that is needed for our man on election evening.

PRESIDENT LELAND: As a property owner in Massachusetts, though, Professor Lutz, and as a property owner in the state of New Jersey, and as one who divides part of his time when in this country between those two spots, isn't it conceivable that you might well be accorded a voice in the local affairs of each of those local jurisdictions?

You spend your winters teaching, let us say, the things you think up during the summers in Massachusetts, and conceivably, then, earn a part of your income in each state. That is only a hypothesis, understand, for the purpose of this discussion.

MR. LONG: That is a new allocated factor, though.

MR. LUTZ: Your hypothesis is wrong. I earn my income in New Jersey, and I turn it over to Henry Long in the summer in the state of Massachusetts. But, unfortunately, Massachusetts is so backward in her election laws that I am not as yet accorded the privilege of voting in Massachusetts. I think I ought to have that privilege.

MR. LAVERY: I would like to give an illustration, as a horrible example, of exactly what happens as you suggest. I happen to

own a sand pile down in Delaware, and the first year after I acquired that sand pile I got a tax bill which had so much property tax, and capitation tax—not decapitation, but capitation, you will notice. So I went to the tax commissioner and I said, "You can't do this to me. I don't live in Delaware."

He said, "Well, where do you live?"

I said, "In Ohio."

He said, "Well, we will let you vote here."

I said, "Why I can't vote in Delaware."

"Oh, yes, you can," he said.

I said, "Why I can cite you any number of cases to show that this is unconstitutional."

"Well," he said, "probably it is, but it is only a dollar and you are going to pay it." I have been paying it.

Robert C. Brown (Indiana): In view of the fact that the question of political rights has been brought up here, let me suggest that you are opening the door rather widely, apart from taxation, in other respects. It is a settled principle of law, as I understand it, that one's personal status is determined upon his domicile. Well, if he has several domiciles which don't agree, he is married, well he is married all the time, but he isn't married some other place, because he is domiciled there and that other place doesn't accept his marriage.

I think if we get the idea that a man can have more than one domicile, we will have to shake up our law considerably, because I don't think that that would be a very practical suggestion.

Mr. Lutz: May I ask the gentleman if he is citing this fact, that if a person is not married in some jurisdictions it is a drawback or objection?

Mr. Brown: I am not passing on the matter. I am merely stating my ideas.

President Leland: Is there any other discussion? If there is no further discussion, this session will stand adjourned.

The luncheon will be in the banquet room to the right of the registration desk, at twelve-thirty. I am told that as you go in there will be someone to relieve you of your money. We hope as many of you will come as possible.

(The meeting thereupon adjourned at twelve-five o'clock.)

SECOND SESSION

MONDAY, OCTOBER 24, 1938, 12:30 P. M.

(LUNCHEON SESSION)

SIMEON E. LELAND, presiding.

CHAIRMAN LELAND: I want to get on the right page of this program, because if I don't we might have the wrong things.

I appreciate the attendance here today. The program committee decided that all of you would have to eat somewhere, so we thought it would be a good idea to eat together.

We are honored today to have with us Mayor Reading of Detroit. I was out yesterday when some of you were looking for me. I learned some first-hand things about the city. I have a friend here who I have never heard say very many good things about anything or anybody, and he is quite an impartial observer of things that go on in the vicinity in which he lives. He gave a good account not only of the Detroit affairs but of the city administration, and the mayor in particular.

I spent some time looking around impartially myself, and so I know that I can introduce Mayor Reading as a good mayor of a good town.

MAYOR RICHARD W. READING (Detroit, Michigan): Mr. President, Honored Guests, Ladies and Gentlemen: First I want to thank your president for the very flattering introduction. He referred to the program, saying he wanted to be sure to get on the right page. Now I will tell you, Mr. President, had you looked you would have found "reading" is on every page.

I am delighted to be here today to have this opportunity to extend greetings and to those from without our gates a cordial, hearty welcome to this dynamic city. It is nice to have you here. Detroit is very proud to be your host. We have many things of which we are justly boastful, not the least of which is the fact that you would come here and honor us with your presence. We hope you will have a nice time while you are here.

I note by your program you have a pretty full schedule. For about four years I was a city assessor. It was my duty then to assess property for taxing purposes. Two years later I was city comptroller. It was my job then to have the control of tax moneys. For the past twelve years up until this one, I was city clerk and

sat in on all budget hearings—what we call executive sessions. You know, where you 'gladhand" the fellow outside the door and tell him, "I will take care of that raise," and then go in and rip it out and he doesn't know who did it. Now, as Mayor of Detroit, I sit in where tax budgets originate.

But despite that fact, I am very hesitant to get up and talk to a group of tax experts, because despite that seventeen years of experience, I find that there are so many things about it that I know nothing of. I am pretty much in the position of the teacher who told his pupil there were two kinds of taxation, direct and indirect, and he said, 'Johnny, will you please give me an example of indirect taxation?"

"Well," Johnny said, 'the dog tax."

The teacher said, "Why?"

Johnny said, "Because the dog doesn't pay it." (Laughter). Some of us wonder if the under dog doesn't pay most of it. But we hope and trust you have a successful conference.

Just before I came over here I was handed this program, "Citizens' Organizations and the Problems of Government; Accounting Records as Related to Income Tay Returns; Tax Exemptions," and so on down the line. That is a fine program. I wish I might have the privilege of sitting in on all those sessions. It was nice of you to open them to the public. I think that is splendid. There are so many things that will be discussed which not only the public itself but the public official should know and can benefit by. I am going to try to be over here tonight. I understand one can speak seven minutes. That will be plenty for me, because short fellows never make long speeches.

While you are here, folks, we do hope you have a successful conference. We hope that there will come from it some educational results that will benefit all of us, including public officials.

It is nice to be here. If there is anything in the world which we can do, individually or officially, to make your stay any more pleasant in Detroit, we want to do it. It is hardly necessary for me to tell you that I do not bring the keys to the city over here today. I will tell you why. I have had some experience with tax experts like Ray Berry and others. I know them. I can't imagine them ever taking the time to unlock a door. (Laughter)

So we have just opened up everything for you; not only have we opened our gates to you, but we have opened our hearts as well. We hope you will step right in and have a real good time while you are here. (Applause)

Chairman Leland: The response to this cordial greeting has been left to our good friend and colleague, our esteemed vice-president, Mr. "Al" Stone, chairman of the Mississippi Tax Commission. Mr. Stone!

ALFRED H. STONE (Mississippi): Mr. Chairman, Mayor Reading, and Ladies and Gentlemen: When I accepted the position of vice-president of this association, I did so with a distinct understanding that the historic background of the vice-president's job was to be retained and that he was to be seen and not heard. I think it was a very unkind thing on the part of Mr. Leland to try to bring me into the picture on an occasion of this sort.

It is almost a desecration to spoil a welcoming address like the one we have gotten from our distinguished mayor by attempting to respond to it. All of us here who have ever bought automobiles think we know something about Detroit. FOB Detroit is a famous price tag. In times gone by we have all felt that we have paid tribute to Detroit out of our pocketbooks.

Today—and I say this with the utmost sincerity, and I know I speak for all of you here—we have come, Mr. Mayor, to pay you the tribute of our hearts. That is a good place to stop. I am going to say just a few more words, though. I like to think of these gatherings as not so much the gatherings of tax experts and tax men as the coming together of men and women from all parts of this country.

I have reached the time of life when I look, I indulge in a good deal of retrospection. I wonder sometimes whether we have solved our governmental problems, very many of them, in anything like the final sense, and to anything like the final degree. I doubt it. I think we are still engaged in the greatest problem ever undertaken in the history of mankind, the history of civilization, either ancient or modern, that of determining whether or not, in an area such as ours, continent-wide, including people of every racial stock on earth, every racial stock known to man, with endless diversity of resources, an endless complexity of political, economic and social conditions, one hundred and some odd millions of people are capable of measuring up to the ultimate problems of self-government.

I am not going to indulge in any homily; I am not going to make a speech. I think if these problems of ours ever are solved, they are going to be solved through personal contact. It is an old saying, a sort of slogan, that there is no substitute for experience. I don't think there is any substitute for personal contact.

In the administration of the tax problems of the state from which I come, the state of Mississippi, whatever we have accomplished down there we have accomplished by knowing our taxpayers. We have accomplished it by knowing each other. We have accomplished it by an interchange of our problems, trying to get the other man's point of view, on a tremendously larger scale than that. That, it seems to me, is a fundamental duty and responsibility of every American citizen. Therefore, I think these gatherings furnish an ideal opportunity for all of us from all parts of America to get

together and exchange ideas, exchange views, and learn each other, know something about each other.

I am reminded right there of the fact that one of the greatest eulogies ever delivered in the world was by a senator from my state. At that time he was a representative in congress from Mississippi, L. Q. C. Lamar. He was afterwards a member of Grover Cleveland's cabinet and was put on the supreme bench by Mr. Cleveland.

It was at the close of the Civil War. A man who had stood out as an abolitionist and who had been in the front rank of all of those who had tried to prevent the success of the southern secession movement was Charles Sumner of Massachusetts. When Mr. Sumner died—he was in the senate at the time—a number of eulogies were pronounced on him, but by common consent the greatest of them all—I think it takes rank as one of the greatest things of its kind in the English literature—was the speech made by Mr. Lamar. He analyzed Senator Sumner's character, and he found in it a great deal that was admirable, a great deal that was splendid, even from the southern point of view. With all the depth of his soul he closed that speech with this thought, and in this language, "My brethren, know one another and you will love one another."

Chairman Leland: Among the things that we are going to attempt to do at this conference is to carry out the injunction that Mr. Stone has just given us. Those of us who have been coming to the tax conference a great many years have formed some valuable friendships, we have sat at the feet of a great many people and have learned much. We are glad to welcome all of our old friends and look forward to making new friendships here.

At our table here today we are particularly fortunate in having with us Professor Plehn, at my right, and Mr. George Lord, at my left. They are typical of the catholicity of interest of our association, one an esteemed professor, now emeritus, the other an emeritus administrator. The rest of us you know.

The only remaining order of business here is the commercial part of our program. At three-thirty, Professor Thomas will meet the committee on homestead exemptions and tax limitations in Parlor B. All of you who are members of that committee are urged, requested, to be present.

At two forty-five, the three round tables that are scheduled for this afternoon will be given. It is well for you to be there at two-thirty so that you can begin on time. The round tables are quite full. I wonder how all of them will finish? But that is the chore for the presiding officer at each round table.

The one on citizens' organizations and the problems of our government will be held in the grand ballroom. That is where the sessions were held this morning. They had so much ammunition that they couldn't get it on one session, and they will have an

adjourned meeting of that round table on Wednesday morning. That one will meet in the Bagley Room, which is at my right.

The round table on accounting records as related to income tax returns will be held in the Bagley Room. The Bagley Room is the room that is just behind the glass doors. That will be at two forty-five.

Then in the Michigan Room, which is at the end of the corridor passing by the elevators and then to the right as far as you can go, the round table on the taxation of car lines will be held. Pay your money and take your choice. There is no admission fee. You can go to as many round tables as you want, you can stay as long as you like, you can pass in and out as freely as you want, only on condition that you don't bang the door.

We hope that if one round table doesn't suit you, you will go around until you find one that does. And let me say, to those of you who can't be in all three, simultaneously—we thought we had better schedule them in different rooms so that one would not annoy the other—the presiding officers and recording secretaries will provide copy for the printed proceedings, and in the proceedings you can read the things that happened in the places where you were not.

We hope that you will attend these round tables, that you will enjoy them, that you will take part in the discussion, and in particular, that you will express your opinion, especially if it is in disagreement with whatever has been said, because out of the disagreements and the clashes of opinion arise the interest which really makes these discussions worth while.

The floor is open to all of you, you know, and we hope that you will take part in the discussion and in the entertainment. If you don't like the intellectual program, why, the entertainment program for the ladies may have an appeal to you, so do whatever you like. Above all, enjoy yourselves and be at the round tables at two-thirty.

That is all at this session.

(The meeting thereupon adjourned.)

THIRD SESSION

MONDAY, OCTOBER 24, 2:45 P. M.

ROUND TABLE CONFERENCES

ROUND TABLE I

CITIZENS' ORGANIZATION AND THE PROBLEMS OF GOVERNMENT

Presiding Officer—Monday Session.

NORMAN MACDONALD, Executive Secretary, Massachusetts Federation of Taxpayers Associations.

Presiding Officer—Wednesday Session.

RUPERT F. ASPLUND, Director, New Mexico Taxpayers Association.

Recording Secretary

Herbert J. Miller, President, Minneapolis Civic & Commerce Association.

Participants:

FRANK G. ARNOLD, President, Nebraska Taxpayers Federation.

J. M. LEONARD, Asssistant Director, Detroit Bureau of Governmental Research.

CARL P. HERBERT, Director, St. Paul Bureau of Municipal Research.

JOE E. LONG, Executive Secretary, Iowa Taxpayers' Association.

FRANCIS B. ELWELL, Field Representative, New Jersey Taxpayers' Association.

HARRY MIESSE, Indiana Taxpayers' Association.

ABBETT PULLIAM, Director, Schenectady Bureau of Municipal Research.

H. C. YOUNG, North Dakota Taxpayers' Association.

RUPERT F. ASPLUND, Director, New Mexico Taxpayers' Association.

RECORDING SECRETARY: Chairman Norman MacDonald, in opening the conference, explained that it was so arranged that in-so-far as possible every viewpoint in the field of citizens organizations was to be represented in this round table and the one following on Wednesday morning, and that it had been so planned as to provoke discussion of the different viewpoints which existed among these citizens organizations.

Mr. Frank G. Arnold, president of the Nebraska Taxpayers Federation, then was presented and delivered a paper on "Means of Tax Control to Promote Better Government".

MEANS OF CONTROL TO PROMOTE BETTER GOVERNMENT

FRANK G. ARNOLD

Our studies of government have shown inequalities that work to the detriment of a few taxpayers, but these are few and unimportant as compared with the grand total of waste in government that has been revealed and conclusively proven by the intensive research we have made into all lines of local government.

Again and again we have found the wastrels attempting to divert people's attention from bad administration of government by the ballyhooing from the house tops some small inequality in taxation that was important only to a very few.

It was to put a check on this false propaganda and to give to the taxpayer authentic, dependable information that the research work we have been conducting in Nebraska was originally started.

The big things in life are almost always an accumulation of the small things and so it is with taxes. It is the thousand upon thousand of small governmental expenditures that make the grand total. Strange as it may seem, it has been rare indeed that any individual or organization took the time and pains to study down to the last detail of where their tax money came from, where and how it was expended. That is the basis of the research work we have been conducting in the Central West. Let me give you a concrete example of how these small things made up the large ones.

In Larimer and Weld Counties, Colorado, we itemized, classified and then analyzed approximately 250,000 items in the years for which our survey was made. The grand total for these 250,000 items was $6,700,000, the average item was $26.90, the largest item was $5,756.40 and less than $200,000 of this grand total was in anything like large items.

When you get done with a procedure such as I have described, you show to the people of that community, a world of information that they did not have before. It shows them in plain, simple, everyday understandable language how their money was expended, how and where there was waste, if any, how and where there was

bad administration of government and the best of all, it shows exactly how and where changes should be made in present laws to correct bad administration.

There is one thing I cannot make too strong and that is, you can take any state, I believe, in the United States and if you could raise the money and get competent accountants to give the people the same honest picture of these expenditures they would lose their taste instantly for new forms of taxes and more taxes and their only interest would be to rout the wasters out of office.

I am absolutely confident that if this could be done within, say, two, three or even five years, in the whole United States, it would cause the largest wholesale bloodless revolution the world has ever experienced. If it does not come by that method, eventually we are almost sure to have another Boston Tea Party.

There is one thing about the kind of research work that we have been doing, it appeals to all classes of citizens. There may be a wide difference of opinion and a wide divergence of interest between many individuals and many groups, but you should not lose sight of the fact that in the cause of good government, the laboring man, the professional man, the business man and industrialist have a very common and a very vital interest.

It is certainly the function of every tax organization and every research organization to show these various divergent groups their common interest and if this is done intelligently we know from experience that they will join militantly in the battle for the common good.

Let us insist first on the elimination of the waste in government. We can then more intelligently correct the inequalities in our taxing systems.

Recording Secretary: This paper precipitated a rather lengthy discussion during which numerous questions were asked of Mr. Arnold. The questions relating to the cost of Nebraska government and its tax income were not answered by Mr. Arnold, who suggested that such inquiries should be addressed to him and the information would be promptly given.

The question, "To what do you attribute your Nebraska Tax Effort success?" produced the reply, "Cooperation of all groups." Some wondered if the predominance of farming population was not the significant factor in the Nebraska experiment. A lively discussion ensued when Mr. Arnold was asked for his definition of waste in government. His reply, which was an explanation of an instance where they had found materials that were paid for and not delivered, was then labeled as 'dandelion picking"—good as far as it went, but did nothing to stop the dandelions from reappearing.

The discussion then produced the very fruitful viewpoint that in addition to calling attention to outright dishonesty or failure to

secure the most in value for the tax dollar, there must be an effort which is more basic and which builds up the techniques, the system, the laws, or what not, which will eradicate or minimize these things at their source. Such things as civil service, centralized purchasing and more efficient governmental set-up were offered as examples.

The discussion of this paper disclosed rather emphasized feeling on the part of many of those present that the Nebraska experiment was over-exaggerated so far as its lesson and value to citizens organizations was concerned. On the other hand there was an equally emphasized viewpoint that the so-called Nebraska technique was more effective and valuable than many of the so-called professional or scientific approaches which some organizations employed.

These two viewpoints were again agitated by the next paper which was presented by J. M. Leonard, assistant director of the Detroit Bureau of Governmental Research, covering "Starvation Methods for Making Government Effective."

STARVATION METHODS FOR IMPROVING GOVERNMENT

J. M. LEONARD

The so-called, 'gold-brick' or get-something-for-nothing complex seems to be well-nigh a universal attribute of the human race. It permeates all strata of society—it is found among the privileged classes as well as those who do not own summer estates. It is very fortunate this is the case, otherwise some very estimable people would be forced on the WPA. It is very easy to imagine even the board of directors of a large corporation having a series of chortles over being able to purchase materials for less than cost.

But nowhere, and in no form, is this 'gold-brick' complex found more perfectly developed than in the field of taxation. So far as the measurements are available, there is no noticeable lessening in the demand for public services—it continues ever and constantly on the way upward to more and more money to be spent by government for more and more services.

Of course it is true that the demand is not uniform among all social groups, however, it is more a difference of opinion than a difference in basic philosophy. The lowly WPA worker dreams of large relief appropriations, but the non-worker, not on WPA does not appear to want to interrupt the dream—he would only substitute a different kind of work and perhaps more of it. There is no great objection to the enormous sums spent for police services in this country—something in excess of 300 million a year and likewise fire services get considerable applause. Education also becomes a peculiarly popular activity, in that commerce and industry by demanding a higher percentage of their employees be high school

or college graduates, force parental approval of a high school or college training in order that their children can be employed by commerce and industry demanding a high school or college training. The list can be continued indefinitely. One group is considerably concerned that their pet activity of government is not being treated in the manner they believe is essential for the peace, health and safety of the country—a second group, just as powerful, sees an un-American influence in the manner in which their particular activity is treated by a legislative body and a third group, equally powerful politically as the other one, sees the decay of American institutions in lessened expenditures for the special activity they have selected for special attention.

Remember there are at least three layers of government—federal, state and local—and that the activities number in the hundreds in each level—hence there is no wonder that in the course of time, each group striving against the other that governmental expenditures have constantly increased, and at present give every appearance of continuing to increase. The difficulty does not lie in the demand for services, but only in the financing, a minor consideration to most pressure groups. But the mounting cost does get some consideration, when certain selected groups realize that taxes are uncomfortably high.

When the full realization breaks that the cost of government, in answer to the demand for services is becoming a significant factor, then immediately according to good old American custom, 'something must be done about it.' At first the activity was chaotic—consisting mostly of hiring a loud mouthed person who by means of threats and coaxing, was able to secure special treatment for his client. The difficulty with this method is that it defeated its purpose—because a lot of people got to do the same thing. And also the word 'racket' so correctly applies to such methods, that it has fallen into disrepute.

But there emerged two great movements to curb the every ebullient desires of the people for more governmnt. The first of these was the so-called 'scientific' system. This consisted upon an attack on the source of governmental revenues—taxes. Either by tax limitations, or authorizing new types of taxation, the pressure of the cost was thought to be lessened. How? By shifting the burden to the shoulders of some other group of taxpayers. Which brings up the definition of a 'just' tax as is one that some other person pays.

Of course, any approach to adjusting the tax burden is done under the guise of aiding the widow, orphan, the aged and infirm, charity institutions and such. It may, but only in a minor degree, but it does lend dignity to the whole procedure. Do changes in the tax base solve the problem? Not noticeably, but they do give the burden to others to carry. Do tax limitations solve the problem?

Not appreciably. In Michigan with a 15 mills tax limit, more taxes are being collected in the state than ever before. The proponents purposely left so many loopholes that the aid given is only to specific groups.

In other words, any program of curtaining governmental costs by limiting taxes or authorizing new sources of revenue, is only a palliative at the best. The sole purpose is to shift the tax, but when the group to which it has been shifted suddenly finds out what has happened, it looks for other shoulders to which it can transfer the tax. The only basis of a program operating by taxes is to stop the source of the demands. In other words, to prevent the high taxes, you endeavor to stop the demand for services.

This gives rise to the second great method of tax reduction—called in this paper, the 'starvation' method. Here the demand for services is met with a clarion cry of 'waste', 'extravagance' 'unnecessary' and similar and more explosive words. By raising a loud and raucous voice against all expenditures, it is hoped that in time, taxes will be lowered. The basic philosophy is that if source of taxes can be curtailed, demands for services lessened, then economy and efficiency will result—in other words, the patient is starved into a cure.

Many difficulties beset these plans. A taxpayer group no longer can represent more than a small group of taxpayers—economic life is too widespread and too versatile. But of even more importance, are the public employees who willfully expend money foolishly, able to change their habits of a lifetime and start to spend economically —an impossible transformation. And finally, the program if successful, loses by sheer weight of the bias arguments, for government, is organized to render services to its citizens, and when it ceases that function, it ceases to be a government in spirit, but only in form.

One of the larger cities in Michigan has a group of citizens with clear ideas of low taxes—and over a period of 25 years, they have accomplished them, by applying the starvation methods so liberally that government exists but feebly. For instance, the assessors office consists of three persons—two ladies of uncertain years whose chief aim in life is to prevent a draft on the back of their necks and a man, receiving $1,800 a year, who is regularly changed each 2 years because the complaints outweigh the salary. By having no worth while assistance, he is kept closely to his office so that thousands of dollars of assessed values never get on the assessment roll. This situation is found in many Michigan cities operating for economy only. If the program wins, the city loses.

Taxpayer organizations of this type feed liberally on publicity most of it as lurid as a torch light procession. Accomplishments are not in proportion—lack of lower taxes is blamed on the perversity of the 'machine', and not on the essential unsoundness

of the basis program. Even if taxes are lowered, the cost cannot be counted in terms of immediate savings, but the effect on the community for many years to come. In general, organizations of this type are no more successful than their predecessors, the approach thru meddling with taxes.

Is there no balm in Gilead? Is there no answer to the problem of ever mounting costs of government, taking an ever increasing share of the taxpayers money, to be spent on propositions of doubtful merit, and in a manner that shows little indication of efficiency or social responsibility?

So far, only one method has shown any promise—that of the bureaus of governmental research. These bureaus start out on the assumption that government is organized to perform services for the people in an efficient and economical manner. To this end they believe that public employees for the most part perform in an inefficient manner because no one has ever told them how to do their job any better. They believe that only by a careful analysis of the job in hand, by application of the best practices developed elsewhere, can government be improved. They seek to educate the public employee to see his job not as an unappreciated servant of the people, or as a pawn of a political party, but as a leader of the community rendering a service which is absolutely essential to the continuance of the city or state or nation.

Of course, they do not always succeed. Some employees are recalcitrant—some are dominated by groups opposed to efficient government—then the bureau uses the single weapon at its command. *Facts.* They publish all the facts in their possession, they tell all who will heed all they know—or at least as much as can be believed—of the situation. And then they wait. Bureaus are not especially concerned in *Forcing* anyone to do anything. Government belongs to the people, and not given into the possession of any single person or group, in politics or out, to force people to conduct it in any God-given manner. It is assumed by most bureaus that if people want inefficient government, they have an inherent right to it, and no one should take it away from them. But likewise, they have the right to the facts of government as are known to those who spend their full time studying it.

The bureau's approach then is on the side of methods and not men. It is an approach to developing new standards and new methods in government. The present general acceptance of modern budget methods, centralized purchasing, better accounting methods, extension of civil service, improved administrative methods, actuarial computations for pensions and debt retirement and a host of other activities, now considered a part of the prosaic part of administration are all a testimonial to the bureau contributions to government. These and other devices commonly accepted; are in part foundations of government but were not introduced either by the

public officials nor taxpayers organization interested solely in reducing the cost of government.

The present flood of governmental expenditures will inundate any group who stands in the middle of the torrent and bids it stop. Far better is a flank attack to force economy and efficiency in the spending—this in the course of time will produce measurable results.

The methods of governmental research bureaus have been widely copied by many organizations which do not like the more academic title. But any taxpayer's association, or economy league, or improvement association which adopts a study of the facts by persons trained in the study of government, are operating a bureau regardless of the immediate name. Most of the best taxpayers' associations, such as is represented by your chairman today, have the bureau approach although not the bureau title.

Have bureaus been uniformly successful? Not by a jugful! They have had their moments to be sure, and they have had their failures. One of the outstanding attributes has been the ability to last over a considerable period of years. Government is going to be a going concern for a very long term of years and any outside agency seeking to have the slightest effect upon it, must, of necessity, be organized on sound lines permitting a long term program. In general, this is the major difference between bureaus and other types of taxpayer's organizations.

Bureaus are not entirely successful when a powerful political machine so dominates the thought of a community that its citizens are immune to any facts concerning the ineffectiveness of government. But even in these communities sufficient persons think the protection of a non-partisan, non-political fact-finding body is valuable, even though not especially effective for the moment.

It must be remembered that in this country, approximately a half million dollars is being given each year for citizen-supported bureaus of research on the various levels. This money is being given to improve the methods of government without any special return except as it accrues to the whole unit.

But this amount is scarcely sufficient to finance an adequate program in most communities. The basic difficulty is that the bureau sells but one commodity—*facts*. And a fact is as romantic as an old-maid in curl papers. Far more interesting is some group who, in each edition of the newspaper, will be willing to call some public official a crook and a jail bird. Bureau financing naturally rests on a relative small group who believe that better methods of government is the greatest charity existent.

The entire bureau movement cannot be told in the few minutes available. Bureaus are a great movement starting shortly after the opening of the century and continuing to grow. The movement is basically sound and is bound to grow even larger. It can count the taxpayers' savings in millions of dollars, but it prefers to count

its usefulness in more effective and efficient government, organized to serve the people for a minimum cost.

RECORDING SECRETARY: Mr. Leonard's paper produced several observations from representatives of taxpayers associations that the so-called scientific research approach, in Minnesota, Indiana, Iowa and Massachusetts, for instance, had proved itself ineffective or too slow to meet the current issues.

Others wondered why there was any conflict between the taxpayers associations' approach or that of a bureau of municipal research. This discussion finally led to Mr. Leonard's reply that he had no objections to the methods of legitimate taxpayers associations of which there were a number, but he did object to such associations when they were only organized to keep some secretary on a payroll and did not have any intelligent program to sell but relied solely on the prejudice of citizens against taxation.

Here again differences appeared over the question whether it was proper for a citizens organization to just ask public officials that taxes be reduced, or whether it was necessary that they bolster that request with some specific suggestion as to how this could be accomplished.

PRESIDING OFFICER: Our next speaker is Carl P. Herbert, director, St. Paul Bureau of Municipal Research, discussing "What We Can Do About Relief".

WHAT WE CAN DO ABOUT RELIEF

CARL P. HERBERT

With twenty-one million individuals receiving public relief in this country, with the past and present cost of relief met in large part on a borrow as you go basis, with posterity burdened with an ever increasing debt growing into untold billions because of it, with candidates for public office vying with one another in seeking votes by promising bigger and better raids on the public credit for our unfortunate one-third, with crackpot schemes such as "thirty dollars every Thursday" springing up everywhere in accordance with the tempo of the times, with government by deficit prevalent in our national and in many state and local governments, with the very foundation of our democracy itself threatened by new social theories, I think it is safe to say that the most important problem before the people of this country today is that of relief.

A brief sketch of public relief in the past and at present shows at what devastating speed it has grown as a financial and social problem. Up to eight years ago relief and allied welfare activities were no particular problem. Food, clothing and shelter were provided by the public to persons who were unable to provide for themselves or whose families could not take care of their own. Relief, then

called charity, was abhorred with the result that persons saved against a rainy day. Families accepted the responsibilities of their less fortunate members, not only because they realized their duty but because they wanted no one connected with them on relief. Direct, not work relief was accepted as the approved method of taking care of our unfortunates. The local community took care of its own, without state or federal aid, at a low cost to the taxpayers.

Then came the depression with its unemployment. In 1932 the federal, state and local governments pooled their resources for the purpose of alleviating suffering. Huge sums were spent on direct relief. Although proven unsuccessful in past periods of economic distress, the cry soon went up for work relief on the theory that, as opposed to direct relief, it would maintain the self-respect and morale of the so-called relief "clients", it would give the public something in return for the bond and tax moneys it expended, and it would aid recovery through increased buying power. Still relief was considered an emergency problem that would adjust itself as soon as the economic conditions which gave it birth, changed for the better. Recently, however, a new social concept of relief has been pronounced officially by a responsible official in the Public Works Administration. Briefly stated, it is the old Grecian and Roman philosophy that government owes every person a living, that every able-bodied and mentally competent man and woman is entitled to a job. If private industry does not provide employment, then government will. All this is premised on the theory that relief is here to stay and that there will be permanently assimilated into our system of government a large section of our population. Today, then, we have the local and state governments assuming responsibility for the persons unable mentally or physically to provide for themselves, while the federal government takes care of the employables through a work program, the overhead and materials cost of which is met by the governmental units sponsoring the projects.

Now let us observe how the cost of direct and work relief and old age assistance has increased in a few typical cities during the past fifteen years.

COST OF DIRECT AND WORK RELIEF AND OLD AGE ASSISTANCE

	1923	1933	1934	1935	1936	1937
Akron		$ 3,837,282	$ 6,508,510	$ 6,081,650	$12,505,763	
Boston	$968,851	15,299,097	22,457,673	27,000,644	30,444,845	$27,500,000
Cincinnati	19,958		11,982,321	21,117,874	17,937,729	16,793,060
Indianapolis	168,160 a	3,090,674	7,844,669	7,191,840	10,325,481	9,473,327
Milwaukee		7,987,363	22,123,627	19,600,253	25,845,847	
Providence	62,455	2,370,595	3,705,282	4,628,964	6,459,301	6,095,955
St. Louis	000 b	6,503,144	18,636,735	17,224,923	19,839,621	13,954,599
St. Paul	66,414	3,003,002	7,329,134	8,652,924	11,540,916	10,211,899
Des Moines	41,496	1,516,823	4,527,658	2,967,199	5,008,472	5,440,225

Note: The figures shown here and elsewhere are for counties. In order to make them more understandable the name of the city is given, rather than the county.

a 1926.

b No expenditures for relief out of public funds.

These figures, however, tell but part of the story because only a portion of the total welfare costs are assembled in this tabulation. Such items as the institutionalization of unfortunates, aid to mothers, children, blind, and veterans, the C. C. C. camps, the N. Y. A., and other allied activities, as well as the cost of private organized welfare, are not included. In order to get a comprehensive picture of the whole welfare costs, figures were assembled for a few cities showing the amount spent for as many of these additional categories as possible, although in no case could all of the costs be brought together. In the table below as many of these costs as could be secured are assembled and a yardstick is applied, based upon the total real and personal property tax collections for local and state purposes.

TOTAL ASCERTAINABLE COSTS OF WELFARE ACTIVITIES AS COMPARED WITH TOTAL TAXES LEVIED OR COLLECTIONS ON REAL AND PERSONAL PROPERTY, EXCLUDING P.W.A.

City	Total Ascertainable Cost of Welfare 1936	Total Tax Collections
Boston	$40,403,483	$60,014,618
Cincinnati	25,939,223	22,181,221
Indianapolis	11,967,187	16,696,696
Milwaukee	31,693,780	36,187,209
Minneapolis	23,182,404 (1)	26,288,985
San Francisco	23,670,753	30,536,939
St. Louis	22,518,341	29,373,773
St. Paul	14,349,113	14,242,171

(1) 1937.

Certain generalizations are possible from the above figures.

Until last year there was a belief or hope that the relief problem would disappear when the economic condition of which it was originally a product changes for the better. The experience of the year 1936 and early 1937, however, caused a severe shock to any such assumption. It became evident that a regime of high relief costs has become practically permanent regardless of economic conditions. The year 1936 and early 1937 were good years economically speaking. Yet the costs of relief nationally did not appreciably abate. According to the report of the Social Security Board the nation's relief bill for 1937 was only 10% lower than in 1936; the year 1938 promises to be an all time high.

The situation revealed in these figures as you examine them is frankly one which portends insolvency if the tendency is allowed to continue uncorrected.

The total costs of the various forms of relief as shown by the data above now approximate on the average the total tax collections for all local governmental purposes. It is self-evident that these costs are utterly beyond the revenue-raising abilities of these cities

To assume the burden would necessitate a local tax rate generally double its present size which, of course, is impractical.

A large proportion of the money spent on relief and various other welfare categories is borrowed. The federal government is building up deficits approaching the cost of relief financing. Some of our states meet their share of the cost out of current revenue; others meet part of this expense from current receipts and part by borrowing, while still others finance the whole cost out of bond issues. Our cities follow the same procedure as do the states. The necessity for borrowing demonstrates conclusively that today under the present tax system none of the levels of government has shown its ability to meet the cost, and that the costs by and large are beyond the revenue-raising capacities of each. The full impact of relief costs thus has not yet been felt.

Certainly it is safe to conclude that we are living beyond our means so far as relief is concerned.

Now let us turn to the social side of the problem. Why is it that as the national income so substantially increases, there is still a growing relief roll? Why did not unemployment insurance minimize this increase in relief "clients"? Is it because those who are entitled to it prefer the more munificent direct or work relief payments? Did not these persons in many cases fail to save when they were employed because they felt they would be taken care of when they lost their jobs? In other words, can we not say that thrift no longer prevails in this country, increased savings bank deposits to the contrary notwithstanding?

Has there not been a breaking down of the stigma attached to charity, that has further aggravated the relief situation? Then, too, how about family responsibility toward its unfortunate members? Ramsey County, in which St. Paul is located, has an old age pension scheme operating for a number of years before the national act went into effect. Less than nine hundred were on the pension rolls. Within a short time after the federal act was conformed to in this county, the number grew to over five thousand, an increase of approximately forty-two hundred. Of this latter group about twenty percent had previously had contact with relief agencies. It follows that thirty-three hundred persons, who previously had been taken care of by their families in most cases, are now receiving old age assistance because families have shoved their responsibility onto the state. Where checks have been made in other localities, this experience is found to be duplicated.

What is the result of establishing high minimum subsistence standards for relief in a large number of our communities? In one city the standard for a relief client, married and with three children, is $73.10 if he is not working; $97.35 a month if he is working. An unskilled worker on W.P.A. receives $60.50 a month. In this case he would be entitled to supplemental aid to bring the

$60.50 a month up to $97.35. This principle is carried over into private employment. Assume an employee of a department store, married and with three children, earning $89 a month. He is also entitled to supplemental aid of $8.35 a month. This system may become general in the cities. In one of the cities for which we have submitted data, one-sixth of those on W.P.A. are receiving supplemental aid to bring them up to the standards of the minimum subsistence budgets there prevailing. The implications are plain. Under the guise of relief, there has been established a guaranteed minimum standard of living; in one city we have an instance of a man earning $113 a month but who by the subsistence standard applicable to his case was entitled to $115 on relief, and he was given supplemental aid of $2 a month. The result of this application of relief principles must be a levelling off of economic status, for these standards can be maintained only by drawing down those of better income to the level of those of the lower income, except in one contingency, the very substantial increase of the national productive power.

Have we made the getting of relief so easy that we are building up a class of professional paupers? Just fifteen years ago St. Paul had a monthly average of 291 relief cases at an annual cost of $66,000. Today there are over 5,000 at an estimated cost of $3,750,000, or approximately the amount appropriated to operate and maintain our public schools. Further, I am told that this number is to be with us always, regardless of how good our economic conditions may become.

What is to be the result of freezing into our governmental system on a work relief basis an enormous number of persons who are unable or unwilling to find private employment, as is now contemplated by the federal government? The social implications are obvious and the political reactions are apparent to all.

I have attempted to raise only a few of the social questions raised by existing conditions. The answer to these is a challenge to every student of social processes in this country. Certainly enough time has transpired since relief has been a major problem in this country for us to have an answer to the question as to why the big relief load. Yet such an answer has not been forthcoming.

Of course there are those who contend that the solution to the whole problem is improved economic conditions. There is no place in this paper for a discussion as to what is preventing our comeback, although I should like to hear an impersonal, unbiased discussion of the effects upon lack of recovery of the present high income tax in the higher brackets, of other injurious taxation, of labor relations, of the enormous debt burden, and so on.

I am one of those who believe that, no matter how business improves, relief will continue to be the outstanding problem in this country, if the present methods of dispensing it and the theories underlying it are continued.

It seems clear from the figures presented for these few cities that the people in these communities cannot afford to pay for the relief expenditures now being made there. If the people in these particular communities cannot afford it, then the question may be seriously raised, can the country as a whole afford it? The country is merely a great group of such communities, and can only get its money from the people in these communities.

The cost of relief has been obscured from the average citizen, partly because the cost has been deferred in many instances through borrowing and partly because of the mistaken impression that the cost of relief is not a burden upon the people when the money comes from Washington. The people of this country must come to a realization that the cost of relief is eventually met out of the earnings of all the people who work and produce.

I believe that an ideal system of relief would be one in which the local communities, or the communities aided by the states, would assume responsibility for financing and administering relief, under reasonable minimum standards established on the basis of state and local economy. Such a program, however, is impossible of immediate adoption. It is possible, however, to devise a permanent planned policy of relief which recognizes (1) that relief can no longer be approached as a temporary emergency, (2) that relief should be managed on a local basis and under circumstances that provide incentives to efficient and economical administration, and (3) that the total of relief costs must be within the limits of available public revenues or of revenues that can be made available when the states and localities recognize and assume these responsibilities.

To me the present situation is ominous. Relief is dispensed in a manner and at a cost that neither the present nor any yet devised economy can support for a protracted period. Hard-headed business sense is now anesthetized by our hearts, which are running away with us. Social goals must be tempered and balanced by our financial ability to meet the costs or we must expect bankruptcy not only from a financial but also from a democratic viewpoint.

It is the course of wisdom and true humanitarianism to take bearings now that may be followed without disaster to all which includes those whom we mean to assist.

RECORDING SECRETARY: There was unanimous reaction in the discussion following this paper that it raised the important question now before citizens groups and officials as well. There was pronounced evidence that many present believed the time had come to accept relief as a permanent obligation of government on some scale at least and that taxes should be levied to meet the cost as distinguished from our present method of so often using bond issues for the purpose. This precipitated the challenge that it was time we began to think of the taxes which should be levied for this

purpose. While the regressive effect of sales taxes were voiced, no one offered any practical suggestion other than sales taxes for this purpose.

PRESIDING OFFICER: Joe L. Long, executive secretary of the Iowa Taxpayers Association, will tell us "How Official Cooperation in Tax Reduction has been secured in Iowa".

HOW OFFICIAL COOPERATION IN TAX REDUCTION HAS BEEN SECURED IN IOWA

JOE L. LONG

In discussing the developments which have brought about a high degree of cooperation between the Iowa Taxpayers Association and a great majority of public officials in the state, we are not assuming, of course, that the same policies would necessarily bring about the same results in other states.

Iowa is mainly an agricultural state with only two cities of more than 75,000 population, and with ninety-nine counties having an average population of about 25,000. The administration of public affairs is almost wholly in the hands of four administrative groups —state, county, cities and towns, and school boards.

Three-fourths of the members of the legislature come from counties in which the largest city is the county seat with a population of 2,000 to 5,000. The majority of these legislators are farmers or men whose livelihood is directly dependent upon the farmer's friendship and patronage.

The counties are governed by a board of supervisors of not less than three nor more than five members (except for two counties with seven supervisors). With the exception of a number of cities which are governed by a commission of three to five full time commissioners, or by a city manager with non-paid commission, our cities and towns are governed by councils who are paid only a nominal compensation for each meeting. Our 4,800 school districts are each governed by a school board, whose members serve without compensation.

There are, therefore, relatively few of the men and women who have to do with making public budgets and fixing tax rates who are depending primarily upon the public treasury for their income, or who are looking to the holding of public office as a career.

With this background, you can see that we are quite safe in assuming that public officials are just as anxious to make a record of economy and efficiency in their work as we are to have them do so.

In Iowa, as in probably every other state in the Union, almost every candidate runs for public office on a platform of economy and lowered taxes. As soon as he is elected, he is besieged by those

who were active in his support, to make places on the payroll for relatives; fix the street or road past their home; or spend public funds in some way to the private benefit of those responsible for his election.

Not until time for re-election is he likely to hear from anyone who wants him to spend less. Every caller, individual, or pressure group wants something done at public expense. If the official hesitates, there is always the claim that "No one is opposed to this project". As proof, they demand a public hearing and that almost always clinches the point because only the proponents appear and "Nobody objects".

In Iowa we have had a local budget law in force for fourteen years which requires taxing bodies to prepare and publish a schedule of proposed expenditures for the next fiscal year; set a date for a hearing at least ten days subsequent to the published notice; and invite all taxpayers to appear and be heard for or against the proposed expenditures.

During the first eight years this law was in effect, local expenditures soared to an all time peak and, until corn dropped to ten cents per bushel and ruin stared everyone in the face, there had been almost a total absence of taxpayers at these hearings.

In 1932 and 1933 desperate taxpayers attended some of the hearings and demanded drastic reductions and suspension of all public activities that could be reduced or eliminated. Then farm prices improved and the attendance at budget hearings again neared zero. It is not surprising that with no apparent opposition to increased spending, the tax levying bodies continued to give the spenders the best of it.

By 1935 prosperity again began to be considered a permissible topic for speculative discussion, and expenditures and taxes started to zoom upward. To combat this trend, the Iowa Taxpayers Association was formed that year and in its program there was incorporated just one proposed change in the laws of the state. That was a demand for a law "that would give to the taxpayer the right to have his objections to proposed expenditures heard and passed upon by an impartial and disinterested board before the money is spent". The idea was widely publicized and seemed to meet with little opposition. In fact, there appeared to be considerable surprise at finding that this was not already provided.

The law was patterned after Indiana's Budget Appeal Law, and one of the major steps in our campaign was the address at our second annual meeting in November, 1936, by Harry Miesse, father and guardian of the Indiana law, which was heard by more than fifty members of the newly elected legislature.

The law which passed the senate 41 to 4 and the house 86 to 12 established a state appeal board consisting of the state comptroller, an appointed official, and the state treasurer and state

auditor, both elected biennially. This board hears appeals or protests from any local budgets, provided such protest is signed by not less than ten taxpayers of whom *at least three must have appeared at the hearing and made objection to the budget.* In larger communities, the number of signers must equal one-fourth of one per cent of the vote cast for governor at the most recent election. This gives the interested taxpayer a fifty-fifty voice in deciding how much shall be spent for each function of local government, because if he disapproves and his objections are over-ruled, he can (without expense to himself) take the whole matter before an impartial body which is empowered after hearing both sides, "To approve, reduce, or eliminate all items in dispute".

Selling this law to the public officials began with our first suggestion that it be enacted. It was pointed out that the right of appeal from proposed budgets would relieve officials of most of the annoying criticism because of high taxes to which they have always been subjected. If the taxpayer failed to protest, he had waived his right to kick and, if he did appeal, it was just as much his budget as the official's. Quite general approval from leading local officials was given to the proposed law, and this approval has grown rapidly since the law went into effect July 1, 1937.

Appeals have been few, for the *right to protest in most cases does away with the necessity of doing so.* There were ten appeals in 1937 and more than a half million dollars was stricken out of the budgets protested. In Des Moines, a direct reduction of six per cent on 1938 taxes resulted from appeals, and the indirect saving (items eliminated before publication in order to avoid protest or appeal) probably amounted to as much more.

C. B. Murtagh, state comptroller and chairman of the board of appeal, said in his address before our third annual meeting in Des Moines last winter, "That it (the budget appeal law) has been the means of saving the taxpayers of Iowa several millions of dollars, there can be no question".

Most estimates of the savings in the way of reductions and eliminations place the amount at from $5,000,000 to $10,000,000 on the 1938 tax payments. This year there was much greater care than heretofore in preparation of budgets. Taxpayers committees were invited to sit in with officials in making up the schedules of proposed expenditures and, where agreement was reached, public approval was always expressed. Only six appeals were made.

There is, of course, still much to be done in the way of awakening the taxpayers to their rights, but a logical reason for the small number of protests can be best illustrated in the case of Des Moines, where last year all budgets were appealed. A taxpayers committee met with the three major taxing bodies—county, city and school—and talked over the proposed schedules. It was definitely understood that if budgets were less than for the previous year, no

appeals would be taken. In every case items were reduced or eliminated until the schedule was below the previous one (in each instance several thousands of dollars) and all budgets were approved. Where 2,000 or more people attended the hearings on the city budget last year, not a single taxpayer appeared at any of the hearings this year since approval by the taxpayers committee had been announced in advance.

The most cordial cooperation and friendly welcome has been the usual attitude of officials toward the taxpayers organization and budget committees. Exceptions have been few and in many cases were due to untactful approach, or irritating criticism on the part of citizens. In one of the larger cities of the state the city commissioners have used the local taxpayers organization as a very effective protection against demands for new and increased expenditures. When a delegation comes in asking for something new, the response is, "Of course we would be glad to do it if we could, but this taxpayers association would probably land all over us. You go see them first". In most cases the matter does not go any further. This council substantially reduced last year's operating costs and at the election this spring, all five members were re-elected by large majorities. This was the first time in twenty years that an incumbent council had been unanimously returned to office.

We have had more help in organizing local associations from the members of the legislature than we have had from almost all other groups of citizens put together. County and local officials serve enthusiastically on organization committees and boards of directors. At our last annual meeting (held in an off year so far as elections or sessions are concerned) approximately one-third of the members of the legislature were in attendance and heard Norman MacDonald tell the thrilling story of his battles in Massachusetts. I am afraid Norman's story suffered slightly from his shock at finding the governor, the chairman of the state board of assessment and review, the state comptroller, and legislative leaders meeting with the taxpayers leaders and approving their work. I must add that Norman puts his story over so well that I am afraid that I am going to have to ask him back again to keep peace among my members.

Incidentally, some of the members of the last legislature are presidents of their county taxpayers associations and in every case this activity has proved a political asset.

We are undertaking to be fair with public officials and I believe we have largely overcome the natural suspicion with which they viewed us on the start. They were probably justified in anticipating a flood of epithets—cries about "Taxeaters, spenders, grafters, etc."—and when they heard us say kind things about them, they had a right to look and see if we had our fingers crossed or our hands behind us. As a matter of fact, a great majority of our officials are leading citizens who are giving their time at personal

sacrifice as a public service. It is not necessary to change most of our public officials in order to get better government, but it is necessary to so organize and educate the public that their officials will not be compelled to sacrifice themselves in order to protect the taxpayers from those whose income is entirely dependent upon the spending of tax money. And you don't have to have a new set of citizens, either. Many times men have said to me, "That's all right over in Iowa, but down here people are selfish and stingy. They all want the best of it and want somebody else to pay the bill". Whenever and wherever this accusation has been made, I have told them the story of the old ferryman who used to take the settlers across one of the rivers in Missouri when the land to the westward was being settled.

One day a man and his family came on the boat and, as they slowly crossed, the man inquired of the ferryman about a settlement some few miles beyond. "What kind of people are settlin' in there?" he asked. The ferryman, who was something of a philosopher, replied, "What kind of people lived back where you come from?" "Aw, they were a bad bunch, always trying to get the best of you; always willin' to take and take but never willin' to give. We're just hopin' that when we get over yander we'll find some people that are willin' to go fifty-fifty". The old ferryman shook his head and said, 'I'm afraid you're goin' to be disappointed, for you're goin' to find just the same kind of people down thar". The man went on his way, disgruntled and discontented, and the ferryman crossed back over to pick up another family heading for the same settlement.

The same questions were exchanged and the stranger's eyes filled with tears as he said, "The finest people the sun ever shone on. There wasn't a neighbor within five miles of us who wouldn't get out of bed any time of night to help a stranger just as quick as he would a friend. It nearly broke our hearts to leave, but our boys are growing up and we wanted to get into a new country where they could look forward to owning homes of their own, and we're just hoping we'll find some of the same kind of people down here". And the old ferryman laid his arm gently across the man's shoulder and said, "Don't you worry a bit. You're goin' to find just exactly the same kind of people over there".

YOUR people are just about the same as OUR people and the main difference between those communities, large or small, which we look upon as back numbers and those which stand out as beacon lights of progress is to be found in leadership. Usually that leadership is furnished by just one man, or, quite as often, one woman who has a will to work and an intelligent understanding as to what he or she is trying to do.

If tax reform and tax reduction is the job you are undertaking in your state or city, you must deal largely with those holding public

positions and favor. If you will approach your public officials in a spirit of helpfulness; if you will give them some assurance that you will handle the job of selling your ideas to their constituents; if you base your suggestions upon what CAN be done, backed by a reasonable knowledge of existing facts; if you will show equal readiness to give approval to what is fair and right as you do to criticize something that doesn't suit you; if you just use the same horse sense and tactful consideration and salesmanship that you have to use when you sell yourself or your product to your customers or your employers—if you just do these simple things that you regularly do with everybody else but your public officials, I think you can get the same results and the same cooperation we are getting in Iowa.

RECORDING SECRETARY: Aside from some questions relative to the local requirements of the Iowa Tax Appeal Law, discussion of this paper was laid over to the Wednesday morning session.

PRESIDING OFFICER: Francis B. Elwell, field secretary, New Jersey Taxpayers Association will discuss "Making Housewives Think About Government".

MAKING HOUSEWIVES THINK ABOUT GOVERNMENT

FRANCIS B. ELWELL

You are all familiar with the old saying: "The way to a man's heart is through his stomach." Few indeed are the women who do not believe this, and when we add to it every woman's firm conviction that a husband is more amenable to suggestion after a hearty meal, it follows logically that the American housewife puts a great deal of time and thought on her daily menu, and if, as the vast majority of housewives are, she is compelled to keep her table expenditures within a certain amount per week, she must carefully watch the price of the food she selects.

One way, therefore, to arouse her interest in government would be to point out the interrelation between government and food, and make it clear that the cost of government affects the cost of everything she buys for consumption in the home.

Frankly, when we first considered the problem of arousing the interest of the housewife in the affairs of New Jersey we tackled it from another angle.

There are in New Jersey, just as there are in other states, a number of state-wide women's groups already formed, such as the league of women's voters, federation of women's clubs, business and professional women's clubs, college women's clubs, consumers' council, etc. Being already established we believed they would enter into a cooperative plan to weld together their forces for the promotion of statewide activity in the field in which the N. J. Tax-

payers Association was working. Soon we discovered, however, that since each of these organizations was founded for a different purpose, that while the matter of taxation and the cost of government was something that they would consider, they could not be expected to devote enough time to a specialized plan to be of material help to the taxpayers' organization.

This attempt to amalgamate the activities of all of these women's organizations failed, and we believe always will fail, because the women representing these organizations and sitting as members of the taxpayers' board of directors are not able to act for their organizations but must, in every case, report back to them for authority to take part in decisions. Such an arrangement is bound to be unsatisfactory because a board of directors, to properly perform its function, must be able to make decisions.

Moreover there is often a conflict of purpose between such organizations and a taxpayers' group. For example, in considering educational costs some of these groups such as business and professional women's groups include a great many teachers and others whose educational interests are on the side of expanding rather than contracting costs.

Therefore, we have found it a great deal more satisfactory to have our own program separate and apart from women's organizations but to get the cooperation of women's organizations on those planks in our platform about which there is no controversy and to fight out our differences of opinion on the other subjects without prejudice to united action upon those in which we are in agreement.

Realizing the very important part that women play in influencing public opinion and official action by what they know, see and talk about every day, we next tried another plan to get our message to the housewives and to get them organized for action.

We formed a separate New Jersey Women's Taxpayers Association. A large organization meeting was held at the convention hall in Asbury Park. We opened permanent headquarters in Newark and for a time we believed that this plan might work out satisfactorily.

As a matter of fact it did not. A number of contributing factors caused it to fail. One was the inability of the women to agree upon a woman who could undertake the office of president. This is much more difficult in a woman's organization of this type than in a man's. An unknown woman will not receive support. A woman who is well known throughout the state is known because of some special activity.

If the activity is non-political it is usually full-time employment, and she has little time to devote to the taxpayers' association. If she is known because of her political activities, she is ruled out because she is either a prominent and profound Democrat or Repub-

lican and the suspicion immediately arises that she would lean to the political side and not be able to maintain an unbiased and non-partisan attitude.

After this failure our next move was the creation of an elaborate tax display which showed in miniature a taxpayer's house together with the furnishings and equipment that go into a home, labelled to indicate the high taxes paid on each item. This was shown at a number of annual conventions at Atlantic City such as the N. J. State Bankers Association, N. J. Association of Building & Loan, the N. J. Laundry Owners Association, etc. Later it was displayed in the show windows of the larger cities. Everywhere it created a great deal of interest and comment, especially among women.

The housewife is the person who does most of the saving in families, and it is logical that she should take an interest in urging the government to save in its expenditures. Why should the housewife be compelled to lower her family standards in order to keep government budgets at an ever-mounting level? Why should her family have to do without private necessities in order to support public luxuries?

Add to her intimate knowledge of family expenditures accurate information of the cost of government service to her own family, give her a plan of action and an opportunity to organize effectively, and the housewife, in cooperation with her sister housewives will achieve results.

Evidently this was the line of thought back of a new attempt to organize the housewives which started shortly after this tax display I have mentioned above.

This new attack is not our "baby" and it is too early to predict whether it will be successful.

This group proposes to attack the present tax situation by the creation of councils which will form study groups to give the women first-hand information on the tax picture in their local, county and state government. Already about 150 of these councils have been set up throughout New Jersey and several county group meetings have been held. The whole idea seems to be to arouse the women to action by constantly reminding them of the large amount of hidden taxes which they are paying out of their budget allowances for food, clothing, rent, real estate, etc. These hidden taxes are eating up 29c. out of every dollar of the consumer's salary income.

Their platform comprises four planks, as follows:

1. To combat any unsound new tax proposals.
2. To uncover and to oppose all hidden taxes.
3. To demand the repeal of needless taxes.
4. To unite in defense of the American standard of living.

They hope to reach a goal of 100,000 members who will then be an articulate constructive organization able to defend their family's income and their standard of living from any further in-roads by unsound new state and local taxation. Parenthetically I may say it is not difficult to visualize the effect upon federal government of organizations of this kind in each of the forty-eight states. These women point out that 90% of all purchases made in New Jersey are made by women and that women are closer to the problem of prices and the shrinking consumer's dollar than any other group and for that reason should be organized to protect their homes and their families.

This new organization appears to be adequately financed and, of course, that is a most important factor. It takes money to organize anything and it takes a lot of money to organize a movement such as this one on a statewide basis. There appears, however, to us to be a weakness in the present plan. This organization is financed by a special interest, which is in this way seeking to protect itself against the imposition of discriminating taxes. The danger may be that they will use methods intended to be spectacular and dramatic to arouse the women to a position of defense against an unseen enemy, but which in the end may fail, through lack of a definite plan for bringing about results.

When it comes time for spring housecleaning, what good would be accomplished if the housewife stood on the porch with a broom and a pail of hot, soapy water and called the house all kinds of names because it was full of dirt, cobwebs, and moths that had accumulated during the winter. The thing for her to do is to roll up her sleeves, walk right in the front door and get busy, and if this new group is not shown how they can get busy and where they can get busy, and if they do not start to get busy very soon in a constructive way, we fear they will disintegrate.

But whether this organization succeeds or not, eventually we believe that the women will come to realize that the problem of economy in government is so closely related to their own problems as housewives, that they will become fully aroused to the dangers of extravagant waste and unwarranted expenditures in public money. When the searchlight of publicity is more and more thrown on misgovernment and inefficiency, they are bound to realize the inconsistency of carefully watching their own house spigot while they pay no attention to the government bunghole with the tap wide open as it goes splashing all over the place. And by their powerful influence in creating public opinion they will follow solidly behind the woman legislator who addressed her fellow colleagues in a legislative session, as follows:

"If your wives ran your homes the way you are running this legislature, if they spend the family money as you are spending the

state money, every mother's son of you would land in the poor farm."

The conclusion seems inescapable that some day, in some way, housewives are going to be the deciding factor that will force government to reduce its voracious appetite for more and more spending and to begin to practice the rigid diet which so many of its own citizens have been compelled to adopt.

I have told you our experiences in New Jersey. Mostly I admit they seem to be a recital of what will not work—but they are offered with the hope that profiting by what we have not succeeded in doing, others may find the magic key that will help solve the problem of reducing the cost of government and its accompanying burden of taxation.

Recording Secretary: The only discussion following this paper was the comment of several to the effect that one organization of the kind referred to by Mr. Elwell was putting out fantastic data in their state which was harmful to all legitimate taxpayers groups.

The round table adjourned at 5:45 to meet at 9:30 a. m. Wednesday morning.

Continuation of Round Table on Citizens' Organizations and the Problem of Government

Wednesday, October 26

9:45 A. M.

Presiding Officer: The first participant this morning is Harry Miesse, Indiana Taxpayers Association, speaking on "Control of Taxation."

CONTROL OF TAXATION

HARRY MIESSE

In the brief time available for consideration of any subject during a round table discussion, it will not be possible for me to enter into a detailed explanation of what the Indiana Taxpayers Association has accomplished in its efforts to control taxation and reduce the cost of government. However, I may mention a few of the highlights of our program and demonstrate that we have made progress in reducing the burden of property taxes.

As you well know, a game can not be played satisfactorily unless it is based upon rules and the rules are observed. In connection with taxes this means adequate laws governing the imposition and distribution of taxes and affording the taxpayers the right to have some voice in how their money is to be spent. Since the organization of the Indiana Taxpayers Association we have worked in close

harmony with the legislature, obtaining the legislation we deemed necessary to accomplish our purposes, and strengthening these laws as we saw the need for changes. Meanwhile we have had to be watchful whenever the legislature was in session, as opponents of our system of controlling taxes are continually active in their efforts to weaken the laws. Many public officials, promising strict economy when they are candidates, resent interference with their plans after they are elected. Virtually all township, county and city officers in Indiana have organizations of their own and all these groups combine efforts in a single association whose official publication said not long ago that one of its purposes was to represent the officeholders whenever the general assembly is meeting.

Our Indiana tax laws provide that no money may be expended by officials until after they have prepared budgets, outlining their proposals. Property taxes are determined by these budgets. In addition to watching these budgets while they are being prepared, we constantly urge taxpayers to attend budget hearings, examine the proposals and protest before the various units make their adoptions. Our state laws provide that in each county a board of tax adjustment shall function. Some of the taxing units are represented on this board, while other members represent the taxpayers. All are appointed by the judges of the higher county courts. Where county rates are involved we have found that the county councils have been particularly effective in making reductions. The city proposals are studied by the city councils and the town budgets are reviewed by the town boards. However, all of the civil and school budgets in a given county are certified to the tax adjustment board.

We have a tax limitation law in Indiana, but it has some elastic features and officials take full advantage of these. The law seeks to hold property tax rates to $1.25 in rural territory and $2 in cities and towns. The social welfare rate is not included in the limitation total and debt service is excluded. When the budgets reach the county boards of tax adjustment the board members understand that they may not increase any budget or proposed rate submitted to them. They can make reductions, but they can not order higher taxes. If the rate for any unit is approved by the adjustment board at a higher total than the limitation law contemplates, an appeal to the state board of tax commissioners becomes mandatory. This board then determines the necessary rate, but not in excess of that submitted to the adjustment board.

We have heard the argument in Indiana that a tax limitation law is not workable and that all it means is a gesture in the right direction. Our experience has shown that many civil and school units can live within the limitations this law permits, if they will. They have done this by the practice of economy and by taking full advantage of the money distributed by the state. Indiana has a tax on gross incomes of individuals and business concerns. These col-

lections now amount to more than $20,000,000 annually and some of the gross income tax is returned to the local communities. Under the present schedule the state contributes $14,000,000 toward the payment of teachers' salaries in the state. This tax was sponsored by officials who said it would replace property taxes and to that extent it has accomplished its purpose. What we have to guard against, however, is the disposition to levy replacement taxes, absorb them and then discover that governmental costs have increased to the point where property taxes must be raised again to provide additional revenue.

We have another Indiana law that permits taxpayers a voice relative to public expenditures. When any unit of government contemplates a bond issue, a petition signed by taxpayers must be filed, the proposal outlined and public notice given by newspaper advertisements. Our law provides that persons opposing the proposed bond issue may be heard and here the principle of majority rule is invoked. If, for example, a petition for a bond issue is filed with two hundred signatures, those who do not believe the bonds should be issued have the right to file a remonstrance. If there is one more name on the remonstrance than on the petition, the entire proposal must be shelved for at least a year. Thus 201 remonstrators have more power under the law than 200 petitioners. We are urging more general recognition of this legal safeguard. There are frequent occasions when the notice to taxpayers is worded in an evasive manner and their rights not fully set forth. Evidently this is done in the hope that the people will not understand their right to remonstrate and that when they fail to act, the proposed bond issue will be approved.

In addition to the automatic appeal feature of the law, where proposed rates are in excess of the total permitted by the limitation provisions, we have an additional weapon that may be used by the taxpayers. In a unit where the rate is within the maximum permitted by law and where the people believe that still greater economies in government are possible, any ten of them, other than those who pay poll taxes only, may notify their county auditor that they wish to take an appeal. They do not need a lawyer to represent them, nor is there any necessity for the appeal to cost them a cent. The auditor transmits their appeal to the state board of tax commissioners, the board fixes a time for hearing in the county from which the appeal came, and conducts the hearing with one of its members or a representative of the board present to hear the evidence.

These hearings are informal. It is the purpose of the state board to consider the budget items, determine whether they are reasonable or excessive, listen to the evidence submitted by taxpayers and then make a final ruling affecting budget items and the property tax rate

that must be paid. Last year the total budget reduction for all units was $11,000,000.

Our laws insist upon budget integrity. After the budget law went into effect we discovered that officials would make a reasonable estimate for proposed expenditures, contemplating a modest rate of taxation. The public was satisfied and no protests were made. Once the adoptions were made, however, these officials cast the budgets into the discard and began to spend more money through the medium of additional appropriations, such procedure being intended to meet emergencies only. It became our duty to stop that because when this practice prevailed the budgets were no more than preliminary indication of the cost of government. We strengthened the law making it impossible for any additional appropriation to be made and money spent that had not been budgeted unless the need for it was an extraordinary emergency. Additional appropriations must be taken to the state board of tax commissioners for approval. This gives the opportunity for the state board members to inquire into the needs, determine why more is sought than the budgets provided, and approve, reduce or else disapprove the proposals entirely.

The social welfare program is giving us grave concern. In our state the social security projects are administered partly by the federal government, partly by the state and partly by the local officials. Our township trustees continue to be overseers of the poor and they determine the amount of direct relief an applicant is entitled to receive. Some of the county adjustment boards, following their sessions this year, made recommendations that the poor relief law should be changed in an effort to provide greater taxpayer participation in the spending of funds for poor relief purposes. The township trustee is not required to answer to anybody except his own conscience and the possibility of adverse public opinion. It is quite possible that these provisions of the poor relief law will receive attention when our legislature meets in January, as our taxpayers are beginning to assert that the relief program is costing entirely too much, that administrative costs are excessive, that too many investigators and others have been employed, and that something must be done to coordinate control and enforce more economical methods.

We have discovered that it is one thing to provide the public with legal machinery designed to keep taxes down and quite another to persuade the taxpayers to use the machinery. The Indiana Taxpayers Association learned long ago that spasmodic campaigns accomplished little. That is the reason we keep our force intact throughout the year and why we exert constant pressure against waste and extravagance. Our files are so complete and our information relating to governmental units in Indiana so widely accepted that we frequently receive calls from inquirers who explain that they have been to the state house, the city hall or some other public

source of information only to be advised that they can learn more in less time if they come to us, and that whatever we tell them is not subject to contradiction.

When the time comes to prepare budgets we send our fieldmen into every county. Taxpayers are called together in the old-fashioned town meeting kind of conference. They are informed of their rights under the law and urged to avail themselves of the opportunity to check the budgets affecting their taxing units. Our field representatives visit the public officials and offer to assist in the preparation of budgets. We continue this work month after month. Before the legislature meets we issue a comprehensive volume dealing with the cost of government in Indiana, tabulating all of the tax collections, how they are obtained and how distributed, together with comparative tables giving the same information for previous years. These books have become standard reference works. We place one of them on the desk of each member of the general assembly but we have found that the demand does not stop there. Our last issue was soon exhausted and we had to order additional copies for schools, universities, public libraries and many organizations that wanted the tax story told in a way that could be readily and easily understood.

The doors of our office are open every day and we welcome the taxpayer or the official who has a story to tell or who seeks some honorable way to lower the cost of government. We have demonstrated a type of leadership that has won and held public confidence. Without that our efforts would have failed. This confidence has been built largely upon the public realization that we seek to serve no special interest. If we attack a tax rate we are dealing with something affecting the paying of property taxes. If our efforts avail some relief to an individual who is classed as wealthy we have at the same time assisted the owner of a tiny cottage who must count every dollar and who obtains even greater results from our efforts than do the wealthier taxpayers.

We urge continually that the taxpayers show a greater interest in their own affairs. About a month ago the budgets and proposed rates affecting the city of Indianapolis and the townships in Marion County were due to go before the county board of tax adjustment for consideration. We encouraged the formation of an auxiliary organization of taxpayers. It met and elected officers, obtained blank petitions protesting against what threatened to be the highest property tax rate in the history of the community, and sent its representatives into action. That organization filed a petition with the county board of tax adjustment that contained virtually 30,000 names. When the time for a hearing arrived the persons who had affiliated with this group stormed the court house and jammed the corridors. That this type of protest was effective was shown when

the board made its final analysis of the budgets and rates. It ordered substantial reductions in nearly all budgets and brought the rate on property to a much lower figure than had been proposed.

Gentlemen, an association of taxpayers is entirely ineffective and of little use to the persons it seeks to serve, unless it commands confidence and respect. We have built that necessary confidence and respect for the Indiana Taxpayers Association and we propose to guard it through the years to come. We have made the people of Indiana aware that they may look to us for leadership in their behalf. Other associations and groups have been formed for some specific or temporary purpose, but virtually all of them have ceased to exist. It is our business to represent all of the taxpayers all of the time.

Our program, however, would be futile if we were unable to obtain from the legislature the legal machinery we need. Our record shows scores of laws that we sponsored in the taxpayer's behalf. It also shows the defeat of dangerous legislation, fostered by interests that were preparing to make raids on the public treasuries. The membership of a legislature may change, but an association of taxpayers must continue from year to year, preparing fresh evidence to use in support of its program and winning new friends from all walks of life. With this strength, it becomes inevitable that the legislature will look with favor on what we seek, realizing that it is in the best interests of the greatest number of persons.

Our Indiana Taxpayers Association has saved millions of dollars for the citizens of Indiana in the past. It means to go on insisting upon additional savings in the future. The procedure contemplates obtaining the necessary legislation as it is needed. Next is the imperative need for acquainting taxpayers with their rights and urging them to take a greater interest in their own affairs. None of these results can be accomplished without vigorous leadership. We are trying to provide that kind of leadership in Indiana, and if what a grateful public tells us is true, then we have reason to believe that our work has met with success.

PRESIDING OFFICER: Abbett Pulliam, coordinator, New York State Bureau of Governmental Research, will tell us about "Publicity Technique for Expenditure Control."

PUBLICITY TECHNIQUE FOR CITIZEN GROUPS

ABBETT PULLIAM

As executives of citizens' organizations you are concerned with causing large groups of people voluntarily to take certain courses of action.

First, you wish to cause public servants to adopt and execute certain policies.

Second, to support these actions of public officials, or when necessary to demand such actions, you need to motivate a more numerous group of citizens, the general public, and

Third, to assure financial support for your efforts you have to keep before your subscribers information about the work that you do and its results.

Emotions That Cause Action

With these three audiences to appeal to in the normal course of your work, to what basic urges in these groups can appeal me made? How can you concentrate on the result-producing publicity?

First there is the desire of the members of these three groups to survive economically. Much that a citizen and taxpayer agency does can appeal to this desire.

Next, there is the urge of members of these groups to protect their families, in which protection governmental agencies participate, and agencies like yours wield influence.

Then there is the tribal, or civic, instinct which is not so strong as the urges for personal survival and family protection, but is a great factor in any successful government, and is particularly a motive force in citizen and taxpayer organizations.

If you will allow me to hit only the high points, and not be forced to bring in all of the supporting material, certain conclusions can be more quickly given in the form of suggestions or questions which may be helpful in some phases of our work.

Suggestion No. 1 is that we not too quickly conclude that our subject matter lacks emotional appeal, but rather that we re-appraise our publicity methods from time to time to see whether we are reaching those emotions and instincts which cause the kind of actions that we seek.

Five Avenues of Conveying Thoughts

In planning our publicity it may be profitable to keep in mind that we have only five physical avenues of conveying thoughts to our audiences. These are the five senses inherited from primitive man, sight, hearing, smell, taste, and touch.

Here we can learn much from the oldest and largest voluntary association of human action in the history of the world, the Roman Catholic Church. (Parenthetically, in not citing the largest organization in the world, which is the British Empire, I hope I can be forgiven by its architects for intimating that a few hundred millions of the constituents may not be voluntary members.) With the wisdom of the ages and a profound experience in human conduct, the Catholic Church does not overlook a single one of the five elementary senses in conveying its messages to its members.

For sight it has its reading, its crucifix, images, and candles, to mention but a few of its facilities. For hearing it has sermons, music and chants. For taste it has the communion and fasting. For smell it has the incense, and for touch it has the rosary, holy water, and holy objects. The church has perfected a successful technique for the constant dissemination of its message long before the beginnings of our modern publicity practices. I refer you to its success in holding over 200 million contributing members.

This tribute is from a non-Catholic.

Mr. Goebbels and the present German régime have made great strides in perfecting publicity mechanisms, including the press and pageants as symbols for the eye; radio, songs and chants for the ear. However, even the Nazi propaganda work has not gotten beyond the eye and ear approach. So, the American taxpayer movement can expect to find plenty of space for developing publicity technique within the familiar fields of media that utilize the eye and the ear, without launching at this time into the other sensory channels.

Suggestion No. 2 is that we be not discouraged by the modest range of our present technique, but look to the broad fields lying before us for the future development and the expansion of our methods.

Newspapers and Bulletins (or direct-by-mail) articles are still the chief media of publicity for citizen organizations, according to replies from 51 agencies which we have questioned during the last year. Only one out of 45 failed to use the newspapers, and only three out of 48 did not use bulletins.

Radio technique also is developing fast, but today it can be said that most of the material on government and taxation that goes over the radio is spoken by public officials. Preponderantly, it tends to represent the point of view of him who controls current spending and who generally would justify present conditions. Thirteen out of 26 organizations of citizens and taxpayers reported that they use the radio. Some use it weekly. The Wisconsin Taxpayers Alliance prepares a program and arranges for speakers for eleven broadcasting stations weekly, and for one every second week. However, generally speaking, more attention will need to be given to radio if a fair presentation of the taxpayer point of view is to be had on the air.

Suggestion No. 3 is that much more interest be given to the radio possibilities in the work of citizen organizations to exploit the principal modern means of conveying thought through auditory channels.

Speeches and Mass Meetings have their benefits and limitations too well tried and too variable in effectiveness to warrant discussion in our limited time. About 37 out of 42 of the groups hold such meetings.

No Moving or Talking Pictures are as yet used by citizen groups to convey things of interest to taxpayers, according to the questionnaire heretofore mentioned. However, these media are used successfully by governmental agencies in a growing number of city, state and federal departments.

Posters and billboards are used by six out of 27 groups, which is very limited relative to the use of newspapers and bulletins.

Exhibitions of tax and governmental matters are more rare, but have in some cases proved most effective. They are still of limited use.

Governmental Propaganda.—There are certain other media of influencing mass opinion on governmental policies which have been widely adopted by the present régime in Germany, namely pageants, drama, poems, songs, and text material for school classroom use.

Our federal government has utilized these techniques recently, but to a more limited degree than Germany, through W.P.A. drama and music projects, the youth administration, the C.C.C., public forums and other federal agencies.

Ancient kings used pageants, drama, poetry, songs and minstrels to influence public opinion, to build war-like sentiment and to consolidate their control. But these media have as yet had practically no use in presenting the modern citizen and taxpayer viewpoint, although they have centuries of precedent as testimony to their efficacy.

SUGGESTION NO. 4 is that one of the reasons for organizing a country-wide federation of citizen and taxpayer groups lies in the need of joint work to better our present publicity methods, and to explore possibilities in methods not heretofore exploited by these groups.

Pictorial Illustrations, by drawings and photographs are another medium more readily at hand and in more or less use, but seeming to call for more thought and development than we have yet given to it.

Several citizens and taxpayer agencies have in recent times begun the use of such illustrations with apparent benefit. The members of one citizen group voted 96% in favor of the use of pictures in the bulletins sent them. It is obvious in almost all cases, however, that the amount of thinking put into this phase of taxpayer activity has been very much less than given to written publicity. Here is almost virgin territory to open up.

SUGGESTION NO. 5 is that pictorial illustrations be more widely adapted to taxpayer motivation.

Bulletin Publicity. — A review of current literature issued by American taxpayer associations, governmental research groups, and citizens' leagues, suggests several comments.

The vast majority of these organizations has objectives and utilizes practices which affect all citizens and taxpayers alike, proportionately to their stake in taxation and community life. Their work is community-wide in nature, even when their financial support is based on a concern for taxation. This is important as the sheet anchor for all publicity thinking, and gives the best avenue of approach to public opinion.

A few taxpayer organizations give major attention to shifting of tax load from one group to another, which often serves justice, but must of necessity represent minority interests. There is some difference of publicity problems for these groups, but we shall not attempt to treat this now.

More Planning of Publicity Programs appears to be a need in most of our taxpayer and citizen agencies, if we may judge by their literature.

Planning of work programs and publicity is especially necessary when practically no such group in the country is equipped to cover adequately all the activities of the government in its jurisdiction, and all must devote their energies only to the most important activities.

It is only through planning that balanced attention can be given to *repetition, frequency*, and *sequence*, three of the basic considerations in effective publicity.

Planning may mean definite restriction of the field of activity, as has been found by the League of Women Voters, but nevertheless seems to be essential to maximum effectiveness. Hence,

SUGGESTION No. 6 is for more planning of work programs and of the accompanying publicity.

Factual Methods are generally an outstanding virtue of taxpayer association bulletins. In the use of facts rather than opinion and rationalizing these bulletins are probably well above the level of general publicity methods in this country.

In Frequency of Bulletins there is appalling indifference by citizen and taxpayer groups to all the recognized canons.

Monthly issues in small magazines are excellent, as far as they go, and probably should be continued. But more frequent and briefer contacts, particularly with our busy financial supporters, seems to be demanded by every law of advertising, by the practices of the largest organizer of voluntary action in the history of the world, heretofore mentioned, and by the successful methods of the greatest organizer of the masses known to American politics, Andrew Jackson.

President Jackson had an organizing creed which he stated tersely. It had behind it the experience of volunteer backwoods armies which had to be held together by leadership instead of conscription, fixed enlistment periods and European discipline. It was buttressed by experience in setting up the first political organization of the kind that we have today in American politics. It was as follows:

"To give effect to any principles you must avail yourself of the physical force of an organized body of men. This is true alike in war, politics or religion. You can not organize men in effective bodies without giving them a reason for it. And when the organization is once made, you cannot keep it together unless you hold constantly before its members why they are organized."

In an organization of citizens or taxpayers you must hold constantly before its members and supporters why they are organized.

"Constantly"

Some advertisers consider constantly to mean every day. I know some who would not miss two consecutive days in the newspapers. However, for practical reasons and because of the probable reactions of a sizeable percentage of subscribers to citizen and taxpayer association literature, I have come to the rough-hewn and tentative conclusion that the most productive frequency for brief literature sent to financial supporters lies somewhere between twice-a-week and ten-day intervals. Perhaps weekly issues are good for most cases, with certain additional mailings at the time of special events, such as budget-making periods, proposed bond issues, certain holidays and other current happenings, which help to emphasize your message in the minds of those who receive it.

For Contact with Public Officials more frequent communications seem to be desirable. I shall not be satisfied in my own mind as to the best interval until I have seen tried out a daily postcard, or other short communication, to the principal officials. Here also you have to reach a busy man, whether busy with politics or with the public business. Messages that are frequent must be brief. They must be frequent because the official is usually surrounded by people who receive what the taxpayer pays and who benefit generally by more spending, a circumstance which causes the official to be importuned hundreds of times for jobs, salary increases, departmental expansions, neighborhood improvements and other things that add to public costs, to every one time he is importuned by taxpayers to control such costs. He needs the communications that you can send him. And, consciously and subconsciously, he will heed them. You who are, or have been, public officials will, I think, vouch for this.

Newspaper Articles Add Frequency to Contact with both financial supporters and public officials, and help in part to make up for the long intervals between most bulletins' issuances. This is a haphazard method of keeping in touch with your audiences, however, for it depends upon the uncertainty of the newspapers' being read by the people whose interest you seek.

The radio also has this effect of helping to keep constantly before these audiences matters of interest to citizens and taxpayers in the few places where the radio is utilized.

Editorial Selection

To fit the time limit I have omitted some comments prepared on editorial selection of material for newspaper use and for bulletins, as well as on some of the methods used and the costs of bulletin publication. However, the selection of material is of such importance as to warrant being referred to as deserving more attention than many of us have been accustomed to give to it.

Helps Financing

Well executed publicity, according to the returns from our questionnaires, has this virtue: it helps provide its own financial support and also the support for the other activities of taxpayer associations. This generally accepted fact is additional evidence that we have not accorded to our publicity work the study and attention which it deserves.

The underrating of the value of publicity has been particularly a habit of the governmental research profession, although in recent years a number of research units are showing a striking improvement in their publicity and public educational activity. Taxpayer associations have generally done a better job of the publicizing work than have the research groups, with some outstanding exceptions. The weekly bulletins of the research bureaus of Buffalo, Detroit and Philadelphia give a better frequency of contact with their supporters, with key citizens, and with public officials than does the direct-by-mail publicity of any taxpayer association about which we have data.

The Princeton Survey publicity for more than a year gave a good demonstration in New Jersey of a research organization's producing publicity with the skill of writing, effective format and general attractiveness of presentation, although not of what may be considered the best chosen frequency or of reaching those emotional urges which we have heretofore discussed. It is recommended to your attention as an outstanding piece of publicity produced by a citizens' organization.

Below Commercial Standards

It may be courting controversy to say so here, but it appears that there are few if any citizen and taxpayer groups that produce publicity which would be highly rated in the commercial field. In fact, none has come to attention, in a year and a half of collecting data for this and other uses, that would not profit if given the kind of thought and executive attention which shows so abundantly in some of the other activities of these same organizations. Nevertheless, the talent found today in the American citizen and taxpayer movement would appear to warrant the expectation that it will contribute to the advance of publicity technique in the years immediately ahead

in a way that has not been possible during the more formative periods of these undertakings.

Improvements Important

It seems most important for the country that the processes used by citizen and taxpayer agencies be made rapidly more effective. More than any other influence these groups, with a few possible overly selfish exceptions, are leading the fight against those political evils which, in this and other countries and in the present and past epochs, have been identified with the destruction of democratic institutions.

Our public school system, which was expected to become a bulwark against degenerative forces such as spoils politics, is more often a part of the patronage system than a remedy for its depredations. The work of organized citizens for administrative improvements is becoming one of the chief defenses of our American form of government, at a time when there is a world-wide attack on this form within and without our country.

Presiding Officer: Our next speaker is H. C. Young, attorney, Fargo, N. D., who will discuss "The Effects of Federal Grants on Local Tax Rates."

EFFECTS OF FEDERAL GRANTS ON LOCAL TAX RATES

H. C. YOUNG

In the short time allotted to me it is impossible to summarize or even enumerate the many important effects produced on local subdivisional finance through the recent activities of the federal government. Those of us who are interested in efficient and economical administration of state and local government are constantly encountering factors produced by these federal contacts. To even summarize them would be tedious, tiresome and too extensive for the purpose of this discussion. Accordingly, I propose, merely, to set forth some of the more important items which have come to my notice and seem to merit your attention.

In the first place, it is impossible to exaggerate the importance of federal grants supplementing local levies and bond issues to local finances. We are all familiar with the general principle of furnishing aid to local units, which contemplate the supplement of local moneys. The rules and regulations have changed from time to time and the method and type of aid have varied not only with the particular alphabetical administrative body, but also in accordance with new congressional enactments. Heretofore, these matters have been discussed largely from the viewpoint of the immensity of federal expenditures and from the possible general social and economic

benefit. I believe that the time has come to consider these expenditures from the viewpoint of the taxpayer, who is called upon to pay the local contributions to the joint enterprises. The bulk of the money furnished locally is obtained directly from property taxes or from bond issues, which ultimately must come from property taxes. The pertinent questions are: (1) whether the local taxpayer is getting his money's worth for his contributions, and (2) whether he can afford to pay the cost. I am but a private citizen, endeavoring to make a living in these strenuous times, and not on the payroll of any governmental unit or any research bureau or taxpayers' organization, so that I feel free to speak on behalf of the taxpayer, and if some of my statements may seem amateurish, I crave your indulgence.

It would be possible to present to you long tables of figures, detailing local expenditures, used in conjunction with federally aided projects but, instead, I have deemed it more advisable merely to outline some of the more important effects which have been observed from these federal-local financial operations.

I. First, let us consider the federal-state relationship. In order to comply with federal requirements, states have been required to increase old expenditures, incur expenditures for new purposes, embark on new activities, and to submit some state functions to federal control.

The following is a brief enumeration of some of these relationships, having importance to local taxpayers:

(1) Appropriations. It has become the practice of federal authorities to require legislative assemblies to make minimum appropriations for activities of a federal-state nature; for example, in my own state, in 1937 a water conservation board was set up in accordance with federal standards, and the legislature was required to make an appropriation of $112,500 in order to comply with the federal demands.

(2) Many states have placed definite tax and bond limitations upon local subdivisions. In order to evade these constitutional and statutory limitations, it has become the practice to provide new taxing units. Many states incorporated rural electrification units to permit additional bond issues and tax levies. In North Dakota tremendous pressure was brought to bear upon the legislature to pass such a measure both at the 1935 and the 1937 sessions. Fortunately, we did not see fit to indulge in this rural electrification program. However, many other states have provided such taxing units.

(3) Pressure is brought to bear on the states to make special levies for programs which have been initiated by the federal government. For example, most states are now making special levies for old-age pensions to provide funds for this purpose from special taxes.

(4) Where taxes are inadequate, states have been urged to issue bonds to comply with the federal program. Much pressure was exerted in North Dakota to issue bonds in 1935 to take care of the relief situation. While this was not done, yet at the present time the state is increasing its indebtedness for this purpose through the medium of certificates of indebtedness at a rate in excess of $300,000 per month.

(5) Matching. The matching of funds has proved one of the easiest methods to increase local tax burdens. The so-called "free" federal money has a peculiar attraction to governing bodies of local subdivisions. The same is also true as far as states are concerned. The following are a few illustrations.

a. *Highways.* Highways have long been enmeshed in the wiles of a matching program; for example, in North Dakota an allocation of $1,960,000 annually has been made by federal authorities for highway construction. This money is not available unless the state furnishes a like amount. When one considers the fact that the people of my state pay to the federal government, in the form of gasoline taxes, and excise taxes on automobiles, automobile accessories, approximately $2,000,000 annually (though this amount is largely collected and credited elsewhere), it would seem that this federal matching has a very definite effect on our local taxation.

b. *Schools.* For many years there have been various special provisions governing the distribution of money to schools on the basis of schools meeting certain federal requirements.

As an illustration of this type of matching, the following incident may be of interest. In 1932 our association sponsored and obtained the passage of a law reducing the basis of assessment from 75% to 50% of the full value. The measure was strongly opposed by nearly all the taxing authorities, and particularly by local school boards. One of my friends who operates a newspaper in the western part of our state and was a member of the local school board, wrote a vigorous editorial against the proposal. Shortly after this blast we happened to have the opportunity of discussing with him his local school budget. One of the items appearing in this budget was one of $7500 for the purpose of obtaining federal aid. Inquiring about this item, we were informed that this was required in order to obtain federal aid. Further inquiry elicited the information that the federal aid amounted to $750. My editor-friend smiled and admitted that it was cheaper to pay the $750 locally and forget the federal aid, and he even took the trouble to write an editorial to that effect.

c. *Social Security Act.* The Social Security Act requires states to match federal funds to provide for old-age pensions, crippled children, blind, etc. In my state this necessitates an appropriation of $2,600,000 for the present biennial period.

II. *Local Units.* It is only recently that the federal government has had much direct contact with the fiscal affairs of local subdivisions. Now the relationship is often very important. The following are a few of the more striking effects that have come to my personal attention:

(1) Many or most of the federal projects require local subdivisions to furnish a material part of the funds, which usually must be provided through bond issues. Every few days some subdivision has an election to pass on a bond issue. Whether or not these are approved is often dependent upon the activity of local taxpayers' associations. In the largest city in North Dakota the local association has been active for a number of years and has cooperated with the local authorities. This city has been called to vote upon four bond issues, all of which have been rejected; in fact, the last proposition, for extending and reconstructing the auditorium, presented about a year ago, was defeated by a vote of about four and one-half to one. Other communities, where local taxpayers have not been active, have voted many successive issues, until the property tax rates have reached an impossible height. As an illustration,—for 1937 the following are the combined local city, school and park levies for the three largest cities in North Dakota, in the order of their population—the rates being based on a full valuation: Fargo, 19.61 mills; Grand Forks, 28.67 mills; Minot, 28.12 mills; the large difference in rate, represents largely levies to service bond issues.

(2) *Self-liquidating Projects.* In addition to those financed through direct property levies, many federal projects are of the so-called "self-liquidating" type. Personally, I object strenuously to this designation. In the state of North Dakota, back in 1919, we inaugurated a program of "self-liquidating" projects, which was termed the "New Day." Under this program, bonds were issued to finance farm mortgages, to construct a state mill, and laws passed for the construction of houses for our citizens. They were all of the so-called "self-liquidating" type. The real estate loan department has already cost in direct taxes approximately $15,000,000. The state mill, erected at a cost of $3,000,000, has lost over $4,000,000 during its seventeen years of operation. Fifty-seven homes were constructed by the Home Builders Association, supposed to cost the owners $5000 each. The loss of these fifty-seven homes to the state of North Dakota amounted to $400,000, which amount has been paid out of the general property taxes.

Among the more important of these federal projects are slum clearance and municipally owned utilities. A slum clearance program, even if it should prove self-liquidating, will cause considerable difficulty to municipal authorities, inasmuch as police protection, schools, highways, fire protection and other municipal services must be rendered to tax-exempt property and the cost paid for by the

other property owners. Municipal utilities may or may not add to the tax burdens.

(3) *PWA and WPA Projects.* Volumes could be written about the character and value of the various swimming pools, sewage disposal plants, etc., etc., financed partly by local funds. They vary from very valuable and very necessary projects, which will be of great utility to the local subdivision, to those which are costly and without any compensating value. The following are just a few points culled from personal observation for your further discussion.

a. *Projects of No Utility.* For example, we have seen swimming pools built where no water is available and airports established in hamlets undisturbed by landing airplanes.

b. Sometimes the project may be of utility, but develops maintenance costs beyond the capacity of the community. One small city in Minnesota finds itself with a $250,000 auditorium which has an $8000 annual maintenance cost, and no funds available for this purpose.

c. Too many communities have developed a desire to "keep up with the Jones'." Auditoriums, swimming pools and other projects are undertaken merely because some other community may have similar public institutions.

d. Public officials and citizens develop a keen desire to obtain their share of "free" money, and although a particular community may not need any construction work, it will propose useless projects in order to obtain their share of this "free" federal money.

e. Also, those directly on the federal payroll are pressed to develop projects and will promote them to keep the federal money active locally, heedless of added costs to local taxpayers. Federal employees have been known to take an active interest in promoting local projects payable partly from federal grants and partly from local taxes or special assessments.

f. Furthermore, projects are advocated and promoted in the different political subdivisions, regardless of the financial status of the particular unit. Some communities are in a position to issue bonds or make extra levies, while other subdivisions are hopelessly insolvent. We have seen many communities vote bond issue after bond issue, to provide funds for compliance with federal matching projects, until they have reached or will soon approach municipal insolvency.

By these observations I do not mean to convey the impression that federal aid has not been of great value and will continue to be of great value in many localities. What I desire to suggest as a basis of discussion are some of the problems and drawbacks, and with this idea, have pointed out some of the important points wherein federal aid, instead of being a blessing, may prove a curse to the local subdivision. We have had many reports and statements from the federal authorities and also from some of those promoting

local projects. Too little has been said from the viewpoint of the local taxpayers who must foot the bill of additional taxes.

According to the figures published by Edna Trull in her study entitled "Resources and Debts of the 48 States" the total net debt of the states and local subdivisions in 1937 had reached the total of \$14,600,711,119, or \$113.68 per capita. The debt service from this load is already exceeding the capacity of many localities.

The problem of the federal-local relationship, which tends to increase this sum, is one of vital consequence and one which we feel should be discussed from the standpoint of the local taxpayer.

PRESIDING OFFICER: I shall merely read my paper on "Reports to Citizens' Organizations."

REPORTS TO CITIZENS' ORGANIZATIONS

RUPERT F. ASPLUND

We have explained from time to time the various procedures in use in New Mexico for the control of public expenditures, such as budgetary procedure, uniform accounting and reports, annual audits, and the statutory provisions which make it necessary for all public bodies to keep their expenditures within the actual receipts from revenue sources provided therefor.

These measures have been effective to prevent the incurring of unmanageable deficits. As a matter of fact there are practically no deficits.

However, these control devices are not sufficient to prevent waste and to insure expenditures on an economical basis for purchases and services of the most essential character. We, in New Mexico, are, therefore, pursuing a new line of work similar to that which has been carried on in Nebraska under the leadership of Mr. Frank G. Arnold. In fact our taxpayers' associations and leagues have found their inspiration in the work done in Nebraska along this line and the interest was stimulated by two visits to New Mexico by Mr. Arnold. The conferences with him enabled us to outline a series of investigations of the operation of local governments in counties, cities, towns, villages and school districts. In order to initiate the surveys, we resorted to the employment of selected students from the University of New Mexico, paying them \$100 a month each for three months. These students were glad to get these jobs, both for the compensation provided and for the opportunity for practical study of governmental practices. They proved to be very capable and reliable and took a deep interest in the work of determining actual practices, and appraising the quality of the service rendered. Trained in research work, they knew how to discover salient features and by reason of their further training in writing up reports on their studies, they were able to furnish us

with concise reports which were made available to the county officials, to state agencies having jurisdiction over the matter of controlling public expenditures and to the officers of local taxpayers associations.

This type of research and reporting has had a significant effect in arousing the interest of local taxpayers in the administration of the affairs of their local governments. It has demonstrated a practical means by which the average citizen and taxpayer can become acquainted with the operations of government, the services rendered, and the costs.

We have recently met with groups of citizens who were very much in earnest and anxious to do something to improve the efficiency of government but without a background of knowledge and information they are at a considerable loss to know how to go about the business of cooperating with their local officials. Under the procedure suggested of making surveys and appraisal of governmental operations and reporting the results of such studies in simple, comprehensive language, these citizens and taxpayers find it possible to become real factors in improving the quality of their local governments.

We have taken a leaf from the book of accomplishments in the states of Vermont, Maine, Massachusetts, New Hampshire, New Jersey and Connecticut, in stimulating reports of municipal government by competition. We have been very much interested in the results secured in these states. Last summer letters were sent to county clerks, city, town, and village clerks and to superintendents of municipal and rural school systems, suggesting that reports be prepared for the preceding year of a character that could be accepted for publication by local newspapers and would be interesting and intelligible to the citizens and taxpayers of their communities. We attempted to describe the kind of a report that would be beneficial and in doing so called attention to the ten points suggested by Mr. W. H. Hackett, Connecticut Tax Commissioner, upon which the quality of the reports would be judged in the competition planned, as follows:

1. Novelty and attractiveness of the cover.
2. General appearance and orderly arrangement.
3. Setting up of the budget.
4. Presentation of balance sheets and financial status.
5. A striking summary of the most notable achievement of the past year.
6. Quality and substance in reports of the departments.
7. Historical and statistical data about the town, city, or other municipality.
8. Schedule of distribution of expenditures over a series of years.

9. Graphic display of financial and other facts through the use of bar charts and graphs and maps—particularly the facts concerning the indebtedness, delinquent taxes, and expenditures for relief and other particular purposes.
10. Planning section devoted to a report of a local planning board or to the suggestions of an official or unofficial group concerned with the study of the needs and possibilities and future of the municipality.

As a result of this suggestion, several reports were prepared, copies of which were sent to the office of the taxpayers association of New Mexico and some of which have already or will appear in the *New Mexico Tax Bulletin*. It is significant that the preparation of a report is in itself a remarkable stimulus to improvement in accomplishments. It is a characteristic of a profession to make a survey and prepare a report thereon. If, as we hope, public service will eventually come to be regarded as a profession, there should result an improved quality of service and an inclination to want the results made known to patrons, taxpayers and citizens generally.

We thus are attempting to reach our objectives of furnishing adequate information to citizen organizations along two lines — 1. Through the activity of taxpayers associations and leagues themselves, and, 2. Through the stimulation of officials to prepare such reports as will be comprehensive and easily understood by the average citizen.

Of course, as has been suggested, we have our official reports and our audits made at the direction of and under the supervision of our state comptroller. These are necessary to keep the supervising administrative agency fully informed as to the handling of public funds. These reports and audits, however, are voluminous and statistical to a degree so that they do not lend themselves readily to publication in the limited space available in newspapers and could hardly be expected to appeal to busy people. One line of our efforts has been, so far as facilities and the time would allow, to take from the annual audits such information as could be digested by the average citizen. We expect to resort to this type of report to citizens' organizations whenever possible.

With reference to reports made to citizens' organizations, it should also be pointed out that while it is possible to secure a limited number of people to attend a meeting to consider governmental problems, we have found it extremely difficult heretofore to get large numbers to attend a meeting dealing with purely civic and governmental problems. It may be that there has not been a sufficiently appealing program to present for their consideration and that the efforts we are making may have better results. We believe that the cooperation of newspapers should be secured on an extensive scale to publish the reports of the type which has been described. An experiment

was made along this line in Santa Fe when the local daily agreed to provide space on its editorial page for a series of stories on the finances of the city and county of Santa Fe. About a dozen or fifteen such reports were made, setting forth the budgets of the various units, explaining the sources from which the revenues were derived, presenting a compilation of the bonded debts of each unit and including all payrolls of the county, court, roads, schools, and of the municipality. It is believed that the newspapers will gladly cooperate in publishing this information as a matter of interest to their readers and thus the reports will reach a very wide circle.

Mimeographed copies of statements should also be prepared, perhaps in even more condensed form than suggested for the reports themselves, and such condensed reports can be also furnished to the newspapers and perhaps all members of state and local associations for their personal and individual files.

These remarks were prepared to suggest a simple, practical, and feasible way for disseminating information which taxpayers and citizens can easily absorb. A better understanding of the operation of government can be secured and intelligent thought stimulated as to how the quality of that government can be improved so as to attain more quickly the object for which we are all working—that of securing better government at less cost.

Recording Secretary: H. J. Miller, president, Minneapolis Civic and Commerce Association, rather than present his paper on "When the Salt has Lost its Savor, Wherewith Shall it be Salted" felt that the remaining time should be given to open discussion of the material already before the conference and offered the observation that, among other things, the conference should discuss the difference in techniques of citizens' organizations in the large communities as compared with the rural districts, stating that more research and experimentation was needed in industrial centers in order to secure effective approaches to interesting working people in the problems of government.

This was based upon his experience that whereas formerly the interest of such citizens was invaluable in securing more honest or efficient government because of its bearing on their tax bill, many things had intervened in recent years between citizens' organizations and the interest of industrial workers in government. Many of them now believe that the possible direct benefit to them of any tax savings are minor as compared with probable increased income which expanding government can give them; that, therefore, in the industrial communities citizens' organizations must approach workers with the effect of government and taxation upon the security of their jobs and their income quite as much as upon the amount they expend for taxes themselves.

Open discussion then followed which included a statement of a railroad official who explained the questions he would raise and the answers he wished before he approved a contribution by his company to any citizens' effort.

It being one o'clock, it was properly moved and carried that the chairman and secretary arrange a third round table for continued discussion of the valuable material which had been offered to the conference.

The meeting then adjourned subject to convening at a time and place to be later designated.

Subsequent to this adjournment the chairman discovered that owing to conflicts and lack of suitable room facilities, it would be impossible to hold a third conference session.

ROUND TABLE II

Accounting Records as Related to Income Tax Returns

Presiding Officer

Henry B. Fernald, Certified Public Accountant, New York.

Recording Secretary

C. L. Turner, Certified Public Accountant, Philadelphia.

Opening remarks and basis of discussion by Henry B. Fernald

Participants:

Victor H. Stempf, Chairman, Committee on Federal Taxation, American Institute of Accountants, New York City.

Walter A. Cooper, Vice Chairman, Committee on Taxation, New York State Society of Certified Public Accountants, New York City.

James S. Wallace, Director Tax Section, General Motors Corporation, Detroit.

Manuel R. Baca (New Mexico).
P. K. Seidman (Tennessee).
Walter A. Cooper (New York).
John K. Speck (Kansas).
Henry B. Fernald (New York).
E. J. Link (New York).
P. K. Seidman (Tennessee).
Victor H. Stempf (New York).
Walter A. Cooper (New York).
Clyde LaRue (Illinois).

HOWARD L. CHAMBERS (Indiana).
E. M. ELKIN (Pennsylvania).
LEO MATTERSDORF (New York).
WALTER STOKES, JR. (Tennessee).
CHARLES W. GERSTENBERG (New York).

OPENING PRESENTATION

HENRY B. FERNALD

Twenty-five years ago the income tax amendment to the constitution was adopted. In urging the adoption of the amendment it had been stated that tax rates would be low, procedure simple and absolute secrecy maintained. Tax returns were to be brief schedules readily prepared from the ordinary business accounts. Treasury examinations would be no burden to one who kept honest and reasonably consistent accounts. Under the 1913 tax law with the corporation tax rate of 1% and a maximum individual surtax rate of 7% this condition largely existed. Neither the taxpayer nor the government had reason to quibble much over technicalities. Rarely was there enough involved to make a court contest worth while. All this was changed, however, when 1917 war tax rates running to over 60% were made effective. The barest technicalities then could give rise to bitter contests. A fortune might depend on the meaning of a word or the position of a comma.

In the twenty years since the 1917 law was enacted we have not yet settled all disputes as to its meaning. The treasury department still has pending before it or in the courts disputes regarding the meaning of the revenue acts of 1917, 1918, 1921, 1924, 1926, 1928, 1932, 1933, 1934, 1935, 1936, and 1937. It is struggling now to get out its regulations under the Revenue Act of 1938 and is looking forward to a possible new Revenue Act of 1939.

The essential difficulty is that income is an intangible theory or concept rather than a reality or fact. We have not been very successful in trying to define this concept so we can know what it is we are trying to tax. Our Federal Revenue Act in Sec. 22 has to use the dragnet wording that "Gross income" includes "income derived from any source whatever". The act provides, in Sec. 43, that deductions and credits shall be taken for the taxable year in which "paid or accrued" or "paid or incurred" "unless in order to clearly reflect the income, the deductions or credits should be taken as of a different period". We impose high tax rates upon an indefinite and uncertain concept. Most of our court disputes seem not to be as to facts but as to theories or as to technicalities of the law.

Congressmen who enact the tax laws do not pretend to know just what they mean. The treasury department which administers the tax laws, recognizing its liability to error, insists on the right to

cancel or amend, with retroactive effect, any ruling or decision which it makes. The taxpayer, who swears to his return, is not generally expected to have much conception of what it is all about. We find our laws so unsatisfactory that we have come to revising or rewriting them every year. We even in 1935 had a revenue act passed, most of the provisions of which were repealed before they ever became effective. Before the regulations under the 1938 act are issued, we are already talking of the changes to be made by a 1939 act.

In all this uncertainty, taxpayers must continue to conduct their ordinary business affairs if they are to have any incomes to be subject to taxation. Looking at the corporation as the typical business concern, it must keep its accounts, appropriate to the requirements of state corporate law, possibly to conform to the interstate commerce or public utility regulations, securities and exchange commission requirements, and, we may assume, subject to periodic audit by certified public accountants. Yet we know that even though the accounts meet all these standards, the net income which they show may be quite different from that which the treasury department will determine for the federal income tax or the state authorities determine for the state income tax. The extent and complexity of these differences, particularly as they become cumulative from year to year, brings us to the subject of our discussion. The situation presented and some of the questions raised may be outlined as follows:

We have corporate or other laws which require or make appropriate a statement of the corporation's accounts which may not be the same as that required under federal or state income tax laws for settlement of its income tax returns.

For definiteness, we will make the following assumptions and raise certain specific questions:

1. Assume that the books of the corporation state the accounts in accordance with accepted accounting practices so that they meet the auditors' approval and are the basis for proper annual reports to stockholders, reports to Securities and Exchange Commission, Interstate Commerce Commission, or other governmental bodies, and furnish an appropriate statement of earnings for dividend declaration purposes.

This excludes from our discussion cases in which the books of account as kept during the year are not in accord with good accounting practice so that the books themselves or the figures derived from the books might be subject to revision, correction or adjustment before they would be appropriate for corporate statements above referred to.

2. We then recognize that this basis shown by the accounts, which we will here refer to as the corporate accounting basis, will not be in all respects in accord with the basis required by law or

valid regulations or decisions for federal income tax or state income tax purposes. Since we must recognize that the federal income tax accounting basis and the state income tax accounting basis may not be identical in all particulars, we will refer to these respectively as the federal income tax basis and the state income tax basis.

We shall further recognize that we have to deal not merely with the amount of "net income" which may be subject to tax, but also may have to deal with the amount of "earnings", which under federal or under state income tax laws will determine the amount of "dividends" as defined by law for federal or state income tax purposes, which we shall here refer to as the "federal earnings basis" or the "state earnings basis."

From our experience, we know that there are three general lines of difference—

(a) As to amounts properly to be taken into account in the corporate accounts of income or expense which, however, are not to be taken into account on the federal or the state "income tax" basis, and that such amounts may or may not be taken into account on the federal or state "earnings" basis. These include items such as tax-exempt interest, non-deductible losses, income tax accruals or payments, and other items of exempt income or non-deductible expenses.

(b) Differences in the period when items of income or expense are to be considered as includible or deductible on the federal or state "income tax" or the "earnings" bases, as distinguished from the time when they are to be taken into account for ordinary corporate purposes. Among such differences are the questions of when income should be considered as accruable or realized; when deductions for expenditures or reserves are properly to be made; when losses should be charged off, etc.

(c) Differences in bases for computing income or deductions on the federal or state income or earnings basis as distinguished from the corporate basis. For example, the corporate basis for property acquired in a reorganization or through an issue of securities may be quite different from its income tax basis. There may be also differences of opinion as to the proper rate of depreciation or other amortization charges to be taken. The income tax basis for property for any year may not be the result simply of a difference with respect to the transactions by which it was acquired, but may be the cumulative difference due to differences in treatment on tax returns as compared with corporate accounts over a considerable period of years.

3. Under these conditions we may have considerable variation between the statement of income or earnings on the corporate basis and for federal or state income tax purposes.

Certain practical questions then arise:

(A) Is it practicable to try to keep the regular books of the corporation in such a way that they will reflect the accounts not merely on the corporate basis but will also give, through subdivision of accounts, through memorandum accounts or notations, the figures appropriately to be used for federal or state income tax or earnings accounts?

(B) Is it necessary or desirable to keep a separate set of accounting records as formal books or as tabulated records which will give the income tax accounting, as distinguished from the accounts on the corporate basis to be shown by the regular books of account?

(C) Is it adequate and satisfactory to carry the regular set of accounts on the corporate basis and then to try simply to cover differences between corporate and tax bases in a series of reconciliation or memorandum sheets?

These are the particular subjects of discussion that aim to bring out suggestions for the best practical methods of meeting the problems involved.

4. A further point of practical difficulty in the accounting is that the tax accounting involves not merely the figures stated in tax returns as filed, but also the various and sundry adjustments which sometimes over a period of a number of years may be subject of discussion and argument before the board of tax appeals and the courts until there is a final determination as to each year of the appropriate income tax basis for that year, with the possibility that points involved with respect to that year will affect the accounting of other years. When the determination for one year is made, we may have consequent revisions to be made in the accounts of past years whose income tax accounting may still be open or may have been long since closed, besides having future years whose accounts may be affected thereby.

What are the reasonable and practical measures for handling the accounting problems thus presented?

This is a question which many of us have before us and which I hope our discussion will help to answer.

TAX ACCOUNTING VERSUS BUSINESS PRACTICE

VICTOR H. STEMPF

Mr. Fernald has touched upon the three general lines of difference between commercial net income and taxable net income. The first type of variation is implicit in the law, and results from congressional recognition of constitutional limitations and of social and economic requirements. This category includes the items of non-taxable income and disallowed expenses specifically mentioned in the law, which it is unnecessary to enumerate. Suffice it to say

that in a business of any size they constitute but a small part of the differences between tax accounting and ordinary business practice.

Aside from the specific statutory differences, a glance at the commissioner's regulations would lead one to believe that the remaining items of net income were the same for tax purposes as for business, because Article 41-2 of Regulations 94 states:

> "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."

This appears to be a liberal interpretation of the statutory requirement that:

> "Net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

Notwithstanding these good intentions, the commissioner, the board, and the courts have taken a narrow, legalistic position, with the result that there has been created a veritable mosaic of exceptions, incomprehensible to the average taxpayer.

We must limit ourselves to a few general examples to demonstrate existing differences between tax accounting and commercial practice. However, innumerable illustrations are readily at hand in the thousands of cases considered by the bureau and the board of tax appeals.

At the root of much of the divergence between tax accounting and commercial practice lies the difference between the legal concept of "due and accrued" and the conventional accounting application of the principle of accrual. Good accounting practice requires net income to reflect all expenses related thereto which are reasonably liable to occur. The bureau, the board and the courts, on the other hand, hold that only such expenses are deductible as are represented by *fixed* and *absolute* liabilities, and repeatedly deny deductions of expenses or deferment of income on those grounds.

An instance of this attitude may be found in the case of sales contracts which guarantee maintenance during a certain period. It is usually possible to approximate, with reasonable accuracy, the amount of such expenses latent in outstanding contracts. Correct accounting technique requires a portion of the profit on such sales to be deferred to cover the future expenses. For tax purposes, however, the full profit must be reported without provision for the future expenses.

Moreover, several board decisions hold that a taxpayer, who knows from experience that a part of the merchandise sold during the taxable year will be returned during the next year, cannot deduct a *reasonable* estimate for such returnable merchandise. The commissioner and the board also have refused consistently to allow

as deductions, *reasonable* additions to reserves for advertising, legal expenses, freight charges, trade discounts and cash discounts, even though such expenses have been incurred (although indeterminate in amount) and relate definitely to the earnings of the taxable year. In all of these cases, it is difficult to understand how a tax return that includes *no* deductions for such expenses can reflect the taxpayer's true income.

The United States Supreme Court dealt a destructive blow to the recognition of sound accounting principles when it rendered its decision in the case of *Arthur M. Brown* v. *Helvering* (291 U. S. 1934) to the effect that insurance premiums earned in each taxable year may not be reduced by such amounts as experience indicates might have to be refunded on account of cancellation of policies. The court stated in part:

> " . . . But no liability accrued during the taxable year on account of cancellations which it is expected may occur in future years, since the events necessary to create the liability do not occur during the taxable year. . . .
>
> The liability . . . arising from expected future cancellations was not deductible because it was not *fixed* and *absolute*. . . .
>
> The 'Return Commission' reserve here in question was voluntarily established. Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the revenue acts. . . . Many reserves set up by prudent business men are not allowable as deductions. . . ."

This decision of the supreme court is distinctly at variance with recognized accounting principles. Provision must be made for events related to the taxable year which are *reasonably* certain to occur. To recognize only liabilities that are *fixed* and *absolute* is a gross violation of sound business practice.

The illogical treatment accorded deferred income items is nowhere better illustrated than in the case of fees and subscription payments received in advance. In Automobile Underwriters, Inc. (19 B. T. A. 1160), the taxpayer managed an automobile association. Membership fees were payable in advance on a three-year basis. The taxpayer claimed the right to defer two-thirds of such fees on the grounds that it had contracted a definite liability to render future service, and the expense of rendering the service would not be incurred until the second and third years. Although, under sound accounting procedure, the determination of net income clearly required deferment of the income, the board upheld the commissioner that all the fees should be reported as income in the year collected.

The most recent evidence of the commissioner's attitude toward deferred income appears in G. C. M. 20021, promulgated in May, 1938, dealing with advance subscription payments, and holding the

taxpayer to an unsound method of accounting. The preponderance of accounting opinion and conventional practice, of allocating such income to the months to which the subscriptions relate, is ignored, failing to recognize that there are future expenses to be borne in respect of servicing such contracts, entirely aside from the cost of the product itself. Accounting practice has recognized for many years that income received in advance should be pro-rated when the consideration for such receipt still has to be given.

Many variances between tax accounting and business practice can be traced to the opportunist attitude of the department toward certain types of income and deductions. For instance, under proper tax practice as well as under sound accounting procedure, nothing should be accrued as income unless it is collectible. The commissioner, however, has often ignored this well established principle and has required taxpayers to report as income the accrual of interest where genuine doubt existed as to collectibility.

There is a long list of cases evidencing the commissioner's unrealistic position in regard to the accrual of uncollectible interest. In Great Northern Railway Co. (8 B. T. A. 225), the taxpayer owned interest-bearing obligations of a number of corporations, interest on which was in default. Under the regulations of the Interstate Commerce Commission, the taxpayer was not permitted to accrue the unpaid interest for the reason that the debtor corporations were operating at a loss and there was no certainty that they would ever be able to pay. Moreover, the officers of the taxpayer in good faith believed that the interest could never be collected. Despite this, the commissioner insisted upon accruing the interest for tax purposes and asserted a deficiency against the taxpayer.

In another case, *Corn Exchange Bank* v. *United States* (37 F. (2nd) 34), the commissioner attempted to tax as income unpaid interest on loans to a corporation which at the close of the year was in such poor financial condition that it went into the hands of a receiver. Although after many years of delay the taxpayer did receive a small portion of the interest due, at the time of preparing the tax return the probabilities that the interest would be collected were nil.

In Atlantic Coast Line Railroad Co. (31 B. T. A. 730) the taxpayer held certain interest-bearing promissory notes of a steamship company, one-half of whose stock it owned. The steamship company was operating at a loss and for many years its liabilities exceeded its assets. Accordingly, the taxpayer did not accrue any of the interest due, but reported as income only the amounts of interest actually received by it in each year. The commissioner, however, contended that all the unpaid interest should be accrued, even though there was no reasonable expectancy of receiving such

interest. As subsequent events proved, the taxpayer never did collect the interest in controversy.

In Turners Falls Power & Electric Co. (15 B. T. A. 983), the taxpayer to protect stock investments made advances to a cutlery company over a period of five years from 1918 to 1923. The record shows that the cutlery company was chronically suffering from financial embarrassment and that the taxpayer was in imminent danger, not only of not collecting interest upon its advances, but of actually losing part of the principal itself. Although contrary to sound business practice, the commissioner insisted that interest on the advances be accrued and reported as income.

In each of these cases the commissioner was overruled, but this did not change his attitude toward the accrual of uncollectible interest. He did not acquiesce in the Turners Falls Power & Electric Co. and in the Great Northern Railway Co. decisions, and he brought the Atlantic Coast Line Railroad Co. case to the supreme court, where certiorari was denied. No prudent business man takes interest into income when there is genuine doubt as to collectibility. The commissioner's position has been that a realistic outlook by the taxpayer is unwarranted, and that the taxpayer should be held to the form instead of substance in such cases.

In a recent case on this point (American Central Utilities Company, 36 B. T. A. 688) the commissioner in accordance with his usual practice held that interest of doubtful collectibility must be included in income. He was once again overruled by the board but in this instance he has acquiesced in the decision. Taxpayers now have some hope that the commissioner will follow the long established business practice of excluding uncollectible interest from income.

The department's opposition to *conservative* accounting practice is especially evident in cases of bad debts, worthless stocks, depreciation and like items. Prudent business men, naturally, pursue a conservative policy in writing off uncollectible items and in fixing proper depreciation rates. The department, generally, looks askance at such practices, and invariably challenges the write-off and reduces the established rates of depreciation. This difference between the business men's conservative viewpoint and the department's position contributes much to the fund of variances between tax accounting and business practice.

Conservative taxpayers who value inventories in accordance with correct accounting principles often are required to make adjustments for tax purposes. Article 22(c) of Regulations 94 states:

> ". . . An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can as a general rule, be regarded as clearly reflecting his income."

In actual practice, the commissioner ignores this liberal dictum and views with suspicion inventory valuation reserves provided to reduce inventories to a proper basis. In fact, he ordinarily frustrates all attempts to reduce inventories by such reserves, and to that extent the breach between taxable net income and actual net income is widened.

In the case of sales of realty or casual sales of personalty, on the installment plan, proper accounting practice includes in the year of sale only such proportion of the total profit as the payments received in the first year bear to the total payments involved. Under section 44(b) of the law, however, if the initial payment exceeds 30% of the selling price, the entire profit must be reported in the year of sale. Accordingly, book profits may not be used for tax purposes.

Also, in connection with installment sales, tax practice again diverges from business practice by requiring, in the case of a change from the accrual basis, the inclusion in income of the proportionate part of all collections representing income, despite the fact that the accrued profit was already reported as taxable income in prior years. The same income is thus taxed twice. What kind of accounting is this which requires duplicate credits?

Foreign exchange transactions have occasioned many tax difficulties. Both under commercial and tax practice, the net profits of a foreign branch are determined in the main by converting the current assets and liabilities of the branch into American dollars at the rate of exchange prevailing at the balance sheet date. However, when branch operations are not involved, but the taxpayer has accounts receivable, accounts payable, and bank accounts in foreign currency, sound accounting also requires recognition of any loss resulting from differences in rates of exchange. The commissioner does not permit such losses for tax purposes, holding that the loss is deductible only when the asset is liquidated or the liability is discharged.

The commissioner also has adopted a very narrow viewpoint regarding the accrual of taxes, and insists that taxes are deductible only in the period in which they legally accrue, regardless of the consistent method employed by the taxpayer. For instance, the commissioner has in various rulings set out dates upon which, under state taxing statutes, certain state and local taxes accrue, although this date may only fix the base upon which a tax is to be determined or may merely establish a taxpayer's responsibility for the payment of the tax. The rate of tax may not be established until a subsequent accounting period, and the tax itself may be designed to cover still another period. From the standpoint of reflecting the true earnings of a business for a given period of time, such arbitrary tax accruals create a distorted picture of operations. This is particularly true in the case of fractional periods, where the accrual of a local tax on some given day, as

required by the department, throws the entire tax expense into one short period. No tax expense appears in the next period with the result that the true income of neither period is correctly reflected.

Most business men keeping their books on the accrual basis make a practice of apportioning taxes to profit and loss in aliquot monthly charges over the period in which the income upon which the tax is based accrues, or in which the benefit derived from the tax is enjoyed. This procedure has been recognized for many years among business men as correctly reflecting income. In view of the commissioner's attitude, however, the taxpayer is usually required to make vexing adjustments to convert book charges into legal tax deductions.

When bonuses are voted shortly after the close of the taxable year, based on the profits of that year, the obvious and consistent accounting practice is to regard the bonuses as an expense of the year during which the related profits were earned, and to accrue the liability as at the close of that year. The commissioner, however, holds that such bonuses are deductible in the year voted; his position being that all the events relating to the *determination* of the bonus occurred in the subsequent year. This makes a travesty of substance; and the maintenance of financial records on such a basis cannot be condoned.

In connection with "trade-ins" of equipment and machinery, the ordinary accounting practice is to record gain or loss based on the difference between depreciated cost and trade-in value. The commissioner takes the position, however, that no gain or loss is to be recognized, and that the basis of the property acquired is to be adjusted for the under or over depreciation of the replaced item. The treatment is unrealistic and requires many petty and unwarranted adjustments.

When deferred charges, such as advertising and development costs, are applicable to the business of more than one year, it is sound business policy to spread a portion of such expenses over the periods benefited. The attitude of the department is to treat such items as expenses in the year of payment.

Under present accounting practice, organization expenses (such as incorporation fees, legal, engineering, accounting and other expenses) are charged off either at once, or are spread over a short term of years. Under Article 24-2 of Regulations 94, such expenses are not deductible from gross income.

* * * * *

The foregoing variations between tax accounting and business practice make it clear that many adjustments are required to restate actual net income for tax purposes, necessitating intricate records to maintain a reconciliation between the several bases. These adjustments add needless complication and expense to the conduct of

business and the administration of the law. The unrealistic treatment required by the treasury causes many petty annoyances to taxpayers, and makes it difficult to comply with the law. The law should be purged of these legalistic refinements, with a concurrent reversion to the simple fundamentals of Article 41-2 that "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income". A liberal recognition of varied applications of accounting principles in different businesses, in lieu of a rigid policy, would make no appreciable difference in treasury revenues over a cycle of years, and abuses may be minimized by demanding consistency of method within the accounts of each taxpayer. This rule of consistency is recognized as one of the essentials of sound accounting practice.

CONTROLLING THE DIFFERENCES BETWEEN CORPORATE ACCOUNTING AND TAX ACCOUNTING

WALTER A. COOPER

In opening this round-table discussion, our chairman definitely presented two questions to be discussed and, if possible, answered. He asks: "Should we attempt to reflect in the corporate accounts a measure of control for the differences between corporate accounting and tax accounting? And, if so, how should it be done?"

In considering what really amounts to a number of separate, though somewhat inter-related, problems, it is usually found desirable to classify them in some way. This discussion today is no exception. I think it will be helpful if we segregate these differences into several categories based upon the effect of the difference rather than the cause thereof. To save time, I shall hereafter use the term "book basis" to refer to the normal corporate accounting values or bases, even though at times I shall suggest adding to the books certain accounts for tax purposes.

Differences Having no Future Effect

Analyzing these differences, we find, first, that quite a few fall into a category that may be described as differences having no future effect. They result almost entirely from provisions of tax laws which either exempt from taxation receipts which are admittedly income in the ordinary sense or deny the deduction of expenditures which are admittedly expenses in the ordinary sense. They affect only the income of the current year and have no effect on future income or taxation. Most typical of these items are exempt income (such as state bond interest in the case of the federal income tax law, and federal bond interest, in the case of the state income tax laws) and on the deduction side such items as contributions in excess of allowable percentages, or federal income tax which is not allowed as a deduction under the Federal Income

Tax Statute. These, however, present no problem for this discussion because no particular accounting record is required. As they have no future effect, there is no reason to keep track of them other than to facilitate current determination of the amount of each item. Thus, it will be found to be desirable, in the case of a company receiving, for example, numerous items of interest on all kinds of securities, to reflect in a separate income account designated "Exempt Bond Interest" all receipts of that nature. This will save the work of analyzing at the year's end an interest account which may contain interest from numerous and varied sources, some taxable and some exempt.

Annually Offsetting Differences

Our second classification will embrace those types of differences which I would describe as "annual washouts". There are a number of items, expenses principally, and a few income items which, for book purposes, are taken into account in a year earlier or later than is proper for tax purposes. Mr. Stempf has discussed the principal causes of these differences, the non-inclusion of which in one year is offset by inclusion in the succeeding year or vice versa. Hence, the effect of these differences relates only to returns for two successive years and I have found it unnecessary, and not at all desirable, to attempt to reflect these differences in the corporate accounts. Fundamentally, they will appear in any reconciliation between book income and taxable income, and it remains only to make the proper offsetting adjustments in the succeeding year. Thereafter, the differences have no effect, although, of course, as a matter of principle, similar items may arise at the close of each year. These, however, involve new adjustments which are not at all concerned with those for prior years. It has been found unnecessary, therefore, to complicate further a taxpayer's ordinary accounting procedure in an attempt to reflect in the regular accounts these inter-year adjustments.

Adjustments that Affect an Indeterminable Future Period

Our third category brings before us a number of differences which present our most serious problems. These are the adjustments that may have an effect for an indefinite number of future years, sometimes on a cumulative basis. With respect to these differences, it is essential that some measure of control be adopted, either through the medium of accounts embodied in the regular accounting system or through memoranda, working sheets, duplicate accounts or other records. We can not rely upon carrying these items in our heads or on haphazard loose-sheet memoranda which may be lost. How, then, can we provide a satisfactory control for these differences and at the same time facilitate our determinations each year in respect to those items that involve annual differences?

Experience in dealing with these matters over a period of years soon indicates that no uniform system can be applied to all taxpayers or even to all items involved in the case of one taxpayer, and upon analysis we find that the items which have a cumulative or continuous effect over an indeterminable number of future years may themselves be divided into three separate subdivisions.

Surplus Reserves:

The first subdivision involves reserve accounts which are not permitted or recognized for tax purposes. A reserve for bad debts, in the case of a company not on the reserve basis for tax purposes, is a typical example. A reserve for contingencies, which appears on many balance sheets, is another. Reserves of this type, however, require no additions to the accounting system to provide proper control. To cover them, I have found that a simple expedient is to indicate in the ledger account that reserves of that type are surplus reserves for tax purposes and are to be regarded as part of the surplus account. Thus debits against surplus or profit and loss, which are offset by credits to these reserves, will have no net effect, as in the case of any offsetting debit and credit to surplus or profit and loss. On the other hand, charges against the reserves, if they are in the nature of deductible items, are to be treated as any similar charge to profit and loss account. The balance in the reserve at the end of each year will reflect the amounts which have been charged in the past against book surplus without deduction on income tax returns. No further accounting, therefore, seems to be required, although I might observe here that one should be careful to segregate reserves in such a way that no reserve account is partly deductible for tax purposes and partly not deductible.

I have in mind, for example, one taxpayer who normally carried a reserve that was described as a "reserve for bad debts, freight, and discount deductions". From a corporate accounting point of view, that seemed to be quite logical because the reserve, in effect, reflected an estimate of the amount that would not be collected on accounts receivable, either because the debtor could not pay or because he would make some deduction for discount or freight. However, this company had adopted the reserve method for determining the bad debt deduction for federal income tax purposes, and we soon found that a continuance of the practice described would inevitably lead to confusion and possibly a loss of deductions because deductible and nondeductible items were being hopelessly intermingled. The solution there was to divide the reserve into two parts: one representing the bad debt reserve which was deductible for federal income tax purposes, and the other representing the reserve for freight and discount which was not deductible. Thereafter, no trouble was experienced.

Differences Affecting One or More but Not All Future Years:

Our second subdivision of this major classification will embrace those items which do not affect income tax returns each year but may affect tax liability in some presently indeterminable future year. They may carry over for a long period of years without affecting taxable income as compared with book income, yet they involve a basic difference that might become important at some time. Items of this kind are the ones that are most easily lost in the shuffle, particularly if a long time elapses during which personnel may change, and the recollections of those who stay may fail. Typical of these differences is one that occurs frequently when a corporation, which has acquired goodwill or some form of intangible asset having a basic cost recognized for income tax purposes and which at one time may have been reflected in the accounts, writes off such intangible asset. There are many such cases. Adjustments in values of securities are another common example. Those who have had experience with the old excess-profits tax of 1917 to 1921 will recall how fruitful an investigation going far back into the accounts prior to 1913 proved to be when it resulted in unearthing and reinstating costs of assets of this type which in the interim had been written off. The reinstatement thereof, particularly through its effect on invested capital, resulted in the saving of many thousands of dollars in taxes.

Such experiences warn us to take care that similar difficulties do not occur in the future, particularly as we feel certain that because of the lack of adequate details for the early years, all such items were not reinstated.

To meet this problem, I have found that the best advice I can give is that such accounts or assets should not be written off the books by a credit against the asset account, but that a reserve for revaluation or reserve for writeoff should be created in an amount equal to the cost of the asset to be eliminated. In this way, the books will always show the asset cost and an offsetting reserve. This reserve, of course, should be designated a surplus reserve. For accounting or balance sheet purposes, the reserve may always be offset against the asset, leaving zero as the balance, yet the books will always and forever contain a record of the fact that an asset had been acquired at a definite cost but had been charged to surplus in an entry which was not recognized for tax purposes.

The same method can be followed generally in the case of any asset of a more or less permanent nature which is not the subject of annual depreciation or amortization charges. Knowledge of the facts will endure as long as the company's records endure, and is not dependent upon the recollection of any person. Furthermore, the presence of the accounts in the ledger will keep all persons dealing with it on notice. I strongly recommend, therefore, that in the case of any write-off of value, the offsetting entry be recorded

in a separate account as a reserve for revaluation, which, for book statement purposes, can be offset against the asset account, and which will provide a perpetual record of the fact that an adjustment of value, not recognized for tax purposes, has been recorded in the accounts. In the case of write-ups the asset can be shown in two accounts, each bearing the same general title, but described respectively as being recognized or unrecognized for tax purposes, the two accounts being combined for book statement purposes.

Differences Having Annual or Cumulative Future Effect:

Our third subdivision involves those types of differences which have a continuous annual and/or cumulative effect and which usually enter into the determination of the correct income, for tax purposes, each year. Typical of these, of course, are differences between the book value and the recognized tax basis of assets which are the subject of annual depreciation or amortization charges. My own experience has indicated that no one particular method can be recommended as being the best. While I was considering what to say at this meeting, I took occasion to look into a number of cases we had involving this problem, and found that in each case a different system had to be developed. The accountant in this respect has to be like a tailor. He has to understand the taxpayer's method of accounting, the form of records maintained for book purposes, and the use that must be made of the information in those records. With these as the measurements, he must then make the suit to fit and build a record which will provide the necessary control of the annual differences, and at the same time provide a method for determining the correct annual tax figures in comparison with the book figures. The more important factors which must be considered are these:

(1) Whether the differences involves a tax basis that exceeds the book basis or is less than the book basis.

(2) With respect to such accounts as plant asset accounts, the taxpayer's method of accounting therefor. For example, is depreciation computed upon the basis of individual rates applicable to individual assets, a composite rate applicable to all assets, or a classification of assets into several groups, each with a different composite rate?

(3) The extent to which computations of depreciation enter into factory departmental or unit cost computations.

(4) Whether there exists, in addition to a difference in basis, a difference in rates.

(5) Whether or not the net difference tends to widen or contract as the years go on.

(6) The extent to which the correct method for tax purposes has been definitely established, or is still the subject of uncertainty.

We must recognize that we have a double problem (1) to control the cumulative difference and (2) to facilitate annual computations.

In developing our discussion of a method to account for and control the differences in this third subdivision, it is well to start with the simplest problem and thereafter gradually add the further complications that have developed in various cases.

So let us start with a case in which the basic costs recognized for book and tax purposes differ but there is no difference in the rate of depreciation or amortization of such assets.

The principal causes of such basic differences are four in number, as follows:

(1) The adjustment of the corporate accounts to reflect a reappraisal of values.

(2) The use of a March 1, 1913 value, which is unrelated to cost, as a basis for tax purposes.

(3) A difference between the original cost at acquisition recognized for tax purposes and the amount shown in the accounts, which difference may readily develop in cases where the consideration for the acquisition of the property was something other than cash, particularly securities of the taxpayer.

(4) Cases where the present taxpayer is required to use a transferee's tax basis which usually has no relation to the actual cost to the present taxpayer.

The simplest case involves a corporation carrying in its general accounts several major classifications of depreciable assets, each depreciated at its own average rate. Such an accounting system might contain separate accounts for buildings, machinery and equipment, furniture and fixtures, and automobiles. If the recognized tax basis is less than the book basis, the simplest method of control is to divide each of the asset accounts into two parts or two accounts. One should contain the portion of the total book value that is recognized for tax purposes, and might be described as, say, " Machinery and Equipment Account A ", while the second account should contain the portion of the book value not so recognized and might be described as " Machinery and Equipment Account B ". Adding the two accounts together will give the book basis, yet the tax basis and the appreciation or excess value are always shown separately in the corporate accounts.

Similarly, the reserve for depreciation should be segregated into account A and account B, containing, respectively, the depreciation on asset accounts A and B and in determining the taxable income, the depreciation charged to account B, being the portion not recognized for tax purposes, would not be deducted.

At all times the net difference between asset account B and depreciation reserve account B would represent the net excess of the

book basis over the tax basis, to be excluded from either surplus, capital, or such other account as the excess was first credited to. This provides a simple and effective method of control which will show at all times the net accumulated difference between the two bases until such time as the excess book value has been completely written off, at which time the balances in asset account B and depreciation reserve account B should be the same.

On the other hand, if the tax basis exceeds the book basis, the same method, with one addition, can be employed. The first step should be to reflect in the general accounts the additional value, designating the corporate accounting basis as account A and the excess value for tax purposes as Account B, crediting the net excess to an account which may be described as "reserve for net excess of tax cost over book value", or words to that effect. For corporate accounting and statement purposes, this reserve would be offset against the asset debit, leaving as a balance only the corporate accounting values.

Similarly, the reserve for depreciation should be divided into account A representing the regular book reserve, and account B representing the reserve applicable to the additional tax cost. Annually, thereafter the amount of the depreciation on the additional tax basis should be debited against the reserve account first discussed and credited to the depreciation reserve account B. In this way the reserve for the excess tax cost will always equal the net difference between the asset and depreciation reserve accounts B and will constitute an addition to either capital or surplus, depending upon how the difference arose. Gradually this reserve account would be transferred to the depreciation reserve B until such time as the excess cost is fully depreciated, when the depreciation reserve account B would exactly offset the asset account B. Of course, the annual depreciation which is debited to the reserve for the excess tax cost account and credited to the depreciation reserve account B would be deducted from income in determining taxable income.

While I mentioned in my discussion only the adjustments for annual depreciation, appropriate entries along the same line should be made each year for asset eliminations. Furthermore, although I started with a simple case involving only four major account classifications, the same method can be applied to any number of different accounts, provided all involve classifications of assets on some composite basis on which depreciation is computed at an average rate.

The foregoing method will meet the requirements of many cases. It requires modification, however, when the depreciation rate, recognized for tax purposes, differs from the book rate. Many such differences have developed during recent years since the promulgation of T. D. 4422, and the study thereunder of depreciation deductions has led to reductions in rates of depreciation. However,

the general accounting control of these differences is not difficult as it merely requires a further breakdown of the depreciation reserves heretofore discussed. If there is no difference in basic costs, then the ordinary depreciation reserve can be divided into two accounts, one being credited with the depreciation allowed and recognized for tax purposes, and the other with the book depreciation in excess of the amount allowable for tax purposes.

In the event that there also exists a difference in basic costs, requiring the maintenance of A and B depreciation reserves in the manner heretofore discussed, then the A account representing the depreciation on recognized tax cost should be divided into two accounts: one representing depreciation allowed for tax purposes, and the other representing depreciation not allowed for tax purposes. The B depreciation reserve need not be divided as it is not recognized for tax purposes anyway. If it relates to a book value exceeding cost or if it relates to a tax cost in excess of book values, the depreciation should be computed only at the tax rate. Thus in such cases, there would be three depreciation reserves representing, respectively:

(1) Depreciation on recognized tax cost which has been allowed for tax purposes.

(2) Depreciation on recognized tax cost which has not been allowed for tax purposes, due to a difference in rates.

(3) Depreciation on excess book value which has not been recognized for tax purposes or depreciation on additional tax basis costs depreciated at the tax rate.

The second of the foregoing accounts would at all times be the equivalent of a surplus reserve, being a partial offset to the depreciation charged against the company's profit and loss or surplus account. The third depreciation reserve, when deducted from the appropriate asset cost, would represent the net amount of excess value included in capital surplus or some other account or if it is the other way, an additional tax cost offset by a surplus reserve therefor. The foregoing method will make it possible to reflect in the general accounts a perpetual control of the cumulative difference between corporate accounting requirements and tax requirements. But difficulty may be experienced in computing the annual depreciation charges or the proper adjustment for plant asset eliminations. In most instances where composite accounts depreciated at average rates are used, even if there is no difference between the tax and accounting bases, it is necessary to maintain subsidiary depreciation computation schedules which, of course, should be kept in some permanent form by recording the data either in a bound book or working sheets which are permanently kept in some binder. Where there exists a difference between the tax and book bases, it will usually be found desirable to divide these working sheet computa-

tions into as many separate schedules as there are accounts, each one supporting an account that appears in the general records.

Our most complicated problems arise in the cases of corporations using individual depreciation rates for each item of equipment. Here the controlling accounts can be worked out on the principles described for composite account cases, but the maintenance of the details supporting the general controlling accounts becomes much more complicated. In many instances, it has been found desirable to duplicate the portion of the records covering plant asset which requires the use, for tax purposes, of a different basic cost or depreciation rate. Sometimes this means duplicating the entire record but it has been found that once the record has been developed, the work of keeping it up is not very serious. It has been possible, in other cases, to develop a form of card record for plant assets which will show both the corporate accounting and the income tax bases. In still others, the difference can be reduced to a percentage computation. A typical illustration of the latter involves a corporation which re-appraised its assets as of some prior date. At that time, the recognized cost and the then book value was, let us assume, \$800,000, and the appraised value for the same items was \$1,000,000. Thus, the tax cost was 80% of the appraised and adjusted book value. In most such situations, the unit details of the correct cost were not available (which may have prompted making the appraisal). Under such circumstances, the treasury is likely to accept 80% of the appraised value of each item as representing the tax cost of such item. If a detailed plant record is set up on the basis of the appraisal, it is a simple matter to provide the necessary space therein to show the computations on the 80% basis. Time does not permit going into all these possibilities in detail, as there are so many, but the simpler cases illustrated and discussed can be developed and adapted to each particular situation, the results varying all the way from the very simple method in the first illustration to a complete duplication of plant records in the most serious case. But, in any event, whatever method may be adopted for the detailed records, they can always be controlled by dividing the general ledger controlling accounts in the manner described for the very simple case.

ACCOUNTING RECORDS AS RELATED TO INCOME TAX RETURNS

J. S. WALLACE

The answer to the question of whether the books and accounting records of a corporation should be adjusted to conform to the accounts reflected in the income tax returns and settlements depends largely on the size of the business. The accounting records of many small business corporations, the stocks of which are closely held, are

set up and kept to conform to the accounts as reflected in the federal income tax returns, excluding, of course, the accounts which deal with statutory adjustments (non-taxable income and unallowable deductions), and subsequently are adjusted in line with the settlement of the returns.

Fortunately most of the state income tax returns are built up from the federal return and, excepting adjustments required for different basic dates for the valuation of assets, in most cases the small corporation's books and accounting records will serve the purpose for all returns.

The large business corporations, with subsidiaries operating in almost every state, is faced with a different problem. It is neither practical nor advisable to attempt to adjust the accounts as carried for the usual corporate accounting records with the accounts reflected in income tax returns and settlements. It is a well-known fact that large corporation income tax settlements in most cases are not completed for several years after filing the returns. Returns are prepared with full knowledge that controversies will arise between the taxpayer and the taxing officials over many important items of income, losses, and deductions. Pending final settlement of the return for each year, the differences between the accounts as carried in the accounting records and as reflected in the tax returns, except for statutory adjustments (non-taxable income and unallowable deductions), are necessarily tentative. The importance of a record of the differences can not be disputed.

A first step in effecting a reconciliation of the differences between the accounts in the books and in the return is the preparation of statements at the time the return is prepared. Details of adjustments to book income to arrive at taxable net income are available in the working papers of each year, even though the schedule called for in the return is condensed. Asset and liability balances can be adjusted by the preparation of a balance sheet from the books with journal entries setting forth a complete explanation of the adjustments and carrying forward the adjustments of prior years so that the cumulative effect will be reflected therein. When these entries are posted to the proper accounts, the adjusted balances will represent the balance sheet for tax purposes. Changes will be necessary in the journal entries at the close of any year to reflect final settlement of the differences in a prior return. Thus each such adjusted balance sheet will be kept up to date and will be incomplete only as to the years which are still unsettled. This adjusted balance sheet is the method of control of the differences and necessarily must be supplemented by records setting forth the detail of each account that differs from the general records. Only in this way can the proper disposition of the item be accounted for.

Some of the major differences which arise year after year, and which involve detailed calculations, are depreciation, depletion, amor-

tization of patents, licenses, etc., and can best be handled by complete subsidiary books or records setting forth all of the essential information for each asset or group of assets, such as, date of acquisition, cost, estimated life, rate per annum, amount of depreciation, depletion or amortization, and the reserve balance applicable to the cost of the asset, etc., thereby arriving at the deductible expense and asset balances for tax purposes. If desired, memo control accounts can be kept in the general books although the balances shown by such memo accounts will not be used except for tax return purposes.

Security investment records must be set up to account for the variations between the tax basis and the book basis of such investments. These records may consist of a complete set of accounts which contain the essential tax information for each security.

Treasury stock transactions, amortization of discount and expense on long-term debt, deferred charges, unallowable reserves, proper accrual of general taxes, capital charges expensed, and foreign tax credits are a few of the other important items to be considered from the standpoint of special records to be maintained in the tax department.

The nature of the records to be kept for tax purposes, whether in the form of ledger accounts or statements and working papers, is a matter of personal preference. The important consideration is to have a permanent record containing complete details which can be referred to each year and which will permit the differences to be followed through to the proper settlement when each year is closed.

State income tax return differences present a separate problem for each state, but, as I previously stated, fortunately the laws for the most part are patterned after the federal income tax law. Practically all of the important differences between the book accounts and accounts reflected in the tax returns will be carried in the records supplementing the federal returns. Working papers and statements in the files of the state returns will account for the remaining differences in a satisfactory manner.

MANUEL R. BACA: Gentlemen: The papers which have just been read on such an important and interesting subject "Accounting Records as related to Income Tax Returns" deserve praise. And credit should be given to these gentlemen for their work in the preparation of these papers for discussion at this time.

I have listened carefully and have no comment to make except that, while we are on this subject we should go a little farther and include in this discussion the standardization of laws re-eliminating to a great extent the number of returns individuals and corporations are by law required to make. I read recently in a book published by Tax Policy League of New York, of one company doing business in the United States that was required to file 14 reports with the

various authorities at a cost of $850 in 1927 and ten years later, or 1937, the same company had to file, including social security returns, 44,610 returns at a cost of $21,100.

Returns to be filed by individuals and corporations for income tax purposes particularly corporations doing interstate business would no doubt appreciate if states having income tax laws would use and define "income" for purposes of taxation in the same manner as we accountants determine "income" in our work in the preparation of profit and loss statement. Since taxes are based on net income, income should therefore be a definition based on a formula which all states including the government should adopt, then taxpayers would be concerned in the filing of one return for the government and all that would remain for the taxpayer filing returns in other states would be to allocate the income to such other states from this report based on the proper factor as the case may be, I for one would go further. I think states should eliminate income tax collection allowing the government to collect it and re-distribute to the states their share—the result of this would be saving of expense in collecting this source of revenue and there would be also a saving to the taxpayers in determining his tax liability. The administration of the law under this method would become less burdensome and costly. In New Mexico as I understand our income tax law is quite similar to government income tax law.

In making this suggestion I have in mind contract carriers carrying passengers from points within and out of state points, to points within the state and through a state. Above all, I want to make this plain, that I have not heretofore given this matter serious consideration and am merely mentioning this for purposes of discussion.

P. K. Seidman: I believe a great deal of the criticism is overdone and that as a practical matter, there is very little need for adjustment or concern from a record-keeping standpoint. I am of the further belief that very few of you here will hold that the income can be determined on the basis of the books or even in accordance with good accounting practice, if for no other reason than the present day standards that exist with reference to accounting practice.

There is no doubt, at least in my opinion, that the loud bewail of repercussions of tax and accounting differences, as reflected in the books of accounts, has been over-emphasized. Two sets of books are not necessary and there are no extraordinary difficulties produced in the normal run of commercial industries.

The tax return itself makes it possible for a corporate taxpayer to keep its books in its own sweet way, through the schedule of reconciliation of book and taxable income. It is only when adjustments of one year have been carried through to affect other years that real trouble looms.

Of course, the most outstanding example here deals with the question of depreciation. Yet a satisfactory answer is supplied even here by maintaining independent depreciation schedules on the tax basis. True enough, with the utilities and extractive industries, the difference between the tax and accounting basis is so acute as to be a bit troublesome in the matter of fixed assets and depreciation. But as for the utilities, at least, this headache is the result of the difference between prescribed approach by two governmental units and it is hoped that coordination can be effected.

To some extent the banking field finds itself floundering because there is no tie-up as to accounting methods between federal and state examiners, the federal reserve, the Federal Deposit Insurance Corporation and the tax authorities. It may very well be that the approach to the problem is to have uniform and standard methods set up for government control agencies so that they can report alike for statement and tax purposes.

I recognize, of course, in some instances the differences are so serious as to warrant a separate tax ledger but this is a limited situation. It is my contention that books should be kept for corporate purposes and reconciled with the tax return, rather than keeping books for tax purposes and reconciling with the financial statement.

Walter A. Cooper: Whether the data necessary to show the details of the differences between tax accounting and corporate accounting should be kept in separate records or books of permanent nature or whether working papers should be kept in the tax return file, as suggested by Mr. Seidman, is not of great consequence and the method most suitable for any particular taxpayer should be followed. Regardless of the method employed in keeping the details, it is of the utmost importance to provide some measure of general control as to which the keeping of general control accounts in the general ledger, along the lines outlined in my talk, was a method I had found quite satisfactory. In fact, a better general total control in the corporate accounts permits more freedom in the method of keeping the details, and, in the simplest situations, the working sheets in the tax files would then be adequate, while, in more complicated cases, more complete records will be found desirable.

John K. Speck: It is my opinion that one set of books is insufficient to give the necessary information for management purposes and for tax purposes, both state and federal. As one instance illustrating, to my mind, the necessity of maintaining separate records, we may take, for example, investments which for management purposes may be desired to be kept at the market price, whereas for tax purposes in the computation of gain or loss from the disposition of such investments, it is necessary that subsidiary information be

maintained giving the dates of acquirement and costs of the various investments sold during any particular year. Further, with reference to records of depreciable assets it often is the case that for management purposes an entirely different set of rates may be desired from that allowed by the federal government or that by particular states in which the taxpayer does business. In this instance, certainly more than one set of depreciation reserves would be required.

Whether separate permanent records are kept or one general set of books is maintained for management purposes and auxiliary working papers, reflecting tax information, be maintained, is generally a policy to be determined by the management. Whether only one set of records are kept with such subsidiary information or separate permanent records are kept, goes simply to the details and not to the fundamentals of the system maintained since in any event one or the other is necessarily required.

REMARKS OF H. B. FERNALD, summing up discussion: In arranging for the discussion this afternoon, I did so without any advance knowledge of the position our several speakers might take on the subject presented. There was a problem with which we had all been confronted and I felt that I as much as others would benefit by its discussion and that I and others would benefit by hearing the opinions of some in responsible positions who had been faced with this problem and the necessity of meeting it in some practical manner. Without knowing the position our speakers would take, I have listened with particular interest to the discussion as it has developed, and I shall try briefly to summarize my conclusions from it.

We seem to have general agreement on the importance of the problem and the need to take definite steps to meet it, but we seem to have some differences of opinion as to how the problem may best be met.

All the leaders of the discussion, as well as those who have spoken from the floor, agree that unfortunately there are material differences between the results which will be reflected by accounts kept in accord with generally accepted accounting standards and the results to be shown under our income tax laws, rulings and decisions; that such results are or may be of such great importance and may have effects extending over such a long period of years that it is essential to have some adequate form of records to keep track of them.

There has been definite thought expressed that this condition should not exist to the extent that it does, but that our income tax computations should be brought more nearly into accord with generally accepted accounting practices. I think all of us believe this would be desirable. However, I think all of us agree that unless

and until this can be done we have a serious problem to which we must give real attention in accounts and records.

We then have three principal plans presented for meeting the problem.

Mr. Cooper urges that there should be control through the general books, using a series of supplemental or subdivided accounts to this end and building up the necessary detailed subsidiary records under such control in the general books as will insure that these matters, which are sometimes of such great financial importance, shall not be overlooked.

Mr. Wallace believes that this is not the most practical thing to do and urges the keeping of supplemental records and reconciliations as to those items which for income tax purposes require a different accounting from that to be carried for general corporate purposes under generally accepted accounting standards.

Mr. LaRue urges the plan of keeping what amounts to almost a second set of accounts, keeping not merely the detailed records necessary to show the differences in accounting for various items as to which differences exist, but, further, bringing these under control of an adjusted balance sheet and adjusted income and surplus accounts on the income tax basis.

I think that each of these gentlemen recognizes what the other would do and that no one of them would consider that the other plans recommended were wrong or inappropriate; although each sees some reasons why he would prefer the plan he has presented. They confirm me in the correctness of this understanding.

There has been expression to the effect that in some cases the problem is not so serious and can probably be met without very extended and involved records, and I think we can all agree that we do not want to see records which are more involved and extended than conditions require. On the other hand, we have had reference made to cases where it was necessary to keep two complete records of all details of plant and equipment accounts so as to have available the information required for income tax purposes as distinguished from that required for the general corporate accounts.

So then, it seems to me we have presented to us a problem where we recognize the importance of having definite records, adequate in every case to record and keep track of the difference between income tax accounting requirements and the generally accepted corporate standards. I believe we all agree that no one can hope simply to trust to memory or occasional review of isolated statements to keep track of these income tax accounting differences. Then we have apparently three main plans under which the records may be kept of these differences, each one having some definite advantages urged for it, but apparently with general recognition that either plan, if consistently and carefully followed through,

can be made adequate for the necessary accounting for these differences.

I think the record we have made in this afternoon's discussion will be of real value for reference and study, and on your behalf, I extend to those who have led in this discussion and those who have joined in the discussion from the floor our thanks for the valuable contributions they have made to our thought and to the record on this subject.

E. J. LINK: Mr. Seidman, what would you do if you had about 15,000 depreciable items for which a reconciliation was necessary? I am sure that if you had a condition similar to ours in which we depreciate buildings on our books at 1½% on appraisal basis, the government allows 2¼% on transferor's basis and the state in which the assets are located allows 3% on actual cost basis, you would find a lapse schedule would not serve to reconcile the return with the books; especially so if there was further complication because the building was remodeled in part and an addition added, and the remodeled section and the addition are depreciated on cost at the allowed rate.

P. K. SEIDMAN: Mr. Link, does your company maintain three different sets of records?

VICTOR H. STEMPF: Principles are not inventions but discoveries of basic truths; as such they are fixed. On the other hand, accounting practices contemplate 'the application of accounting principles', in respect of which reasonable flexibility is inherently essential. Analogous problems may involve the same fundamental principle, but differences in related circumstances and conditions surrounding the respective cases may fully justify variations in the application of that basic principle. I would like to demonstrate what I have in mind by the example of the young man who graduates from his college engineering course and who knows all of the fundamental principles and formulae relating to his particular branch of science. However, the young man who distinguishes himself in that particular phase of engineering is not the one who knows his fundamental principles and formulae thoroughly well, but the man who finds a new and sound application of the principles which he has learned. All technological advancement bears testimony on this point. So, similarly, accounting is not a stale, static affair, but a dynamic art, charged with the responsibility of keeping abreast of economic trends, and changes in commercial practice. If it is to progress; if it is to serve as a sound, useful tool of industry and finance, it must not be put into a straight-jacket of rigid rules. As a further example of what I mean, take the complicated subject of stating the amount of inventories on the basis of cost or market whichever is lower. The first-in first out-, last-in first-out, retail

method, and base stock methods are all pertinent variations in the application of this principle, any one of which may be appropriate in a given instance, but not in another. Reasonable play must be given in the exercise of judgment in a particular case. As in other arts and sciences, there remain many moot questions in accounting practice and procedure, the gradual solution of which is to be sought earnestly, but we must resist passionately any and all attempts to stultify the art by prescription of inflexible rules and regulations which may seek to freeze good accounting practice by the prescription of 'the one and only right way' of doing things."

Walter A. Cooper: With reference to the security situation, I cite a case of a company that maintained adequate working sheets in its tax files to show that its securities had a tax basis different from the book basis which had been revalued, so that some securities had a higher tax cost than the book figure while others had a lower tax cost.

The treasurer of the company, in deciding to sell certain securities, was led to his conclusion, in part, by the fact that it would involve no tax because the sales price was less than the book value which was all he had before him. The securities in question were sold and the treasurer later was very much upset to learn that the tax cost was much less than the book figure, and the sale involved a substantial tax liability. In that case, the company had adequate records for tax purposes, but there was nothing in the general books and the statements based thereon, which went to the treasurer, to indicate that the tax cost was different from the book figure. Had the general ledger in that case indicated clearly, by means of a tax reserve or adjustment account, that the tax basis was different from the books (which would have been apparent from the statement prepared in accordance with the general ledger), the treasurer would have been on notice that the contemplated transaction would involve a tax liability. That case shows definitely the weakness in keeping these records merely in the tax files without reference in the general accounts from which statements are prepared and submitted to the corporate officers.

While the foregoing might be overcome, in some cases, by requiring that the officers always take up such contemplated transactions with the tax department, such a procedure might complicate matters too much if everything had to be passed upon by the tax department, and it has been my experience that, under such circumstances, the rule is not always followed.

Clyde LaRue: Mr. Cooper, all sales of securities in my company must be approved.

Howard L. Chambers: I am very happy that Mr. Stempf made the statement that he did relative to accounting principles being a

safe-guide. Certainly accounting records always should be kept as to always state the truth as to valuations, as to total liabilites, as to income, and as to expenses.

Any variation of valuation of assets under or over that of cost should be reflected through the use of valuation reserves and/or subsidiary accounts. Certainly but one set of records should be kept although it would naturally follow that reconciliation of the book records with that of the information required by tax reports should be kept as a permanent record.

Some times it may be necessary to maintain subsidiary records for the purpose of preserving cost information as to securities, fixed assets, etc. I recall one instance, however, of a bank that was required to write down its security values to market values. In such an instance it would be necessary, of course, to maintain a subsidiary record showing the cost of the securities until finally sold.

The fundamental thing about this matter of accounting principles, however, is that accounting records should be so kept as to always state the truth.

E. M. ELKIN: In many cases accounting systems are already sufficiently complicated and should not be made more complicated or cluttered up with a lot of adjustments made in arriving at taxable income for income tax purposes. While necessarily a complete record should be maintained to follow through indefinitely on changes between book and taxable income, yet such records should be of a memoranda type. I am more in accord with the opinions expressed by Messrs. Wallace and LaRue, which I believe conform to the views I outlined.

LEO MATTERSDORF: I want to ask Mr. Elkin whether he ever knew of two persons in the same profession who agreed with each other. You will find differences of opinion among two doctors, two engineers and two people of any other profession, so why censure the accountants.

I think the crux of the whole situation which has been discussed here this afternoon is that, as someone has said, income tax laws are neither good accounting nor good law. Of necessity this has to be so because were it otherwise the collection of revenues would be jeopardized. Take the accounting viewpoint, for instance. You have conservative business men and speculators often in the same line of business. The one carefully sets up reserves against this or that contingency; the other does not. The government, speaking generally, disallows the deduction of such reserves. If the rule were otherwise, how easy it would be to avoid income taxes. And so it is from the legal standpoint also. The law must be so written that tax evasion is prevented and the revenues protected. That, I think, is the simple explanation of the bad accounting and legal features we find in our income tax laws.

Walter Stokes, Jr.: Regardless of the number of different sets of books necessary to be kept because of various tax considerations, the attitude of the collecting authority should be that of complete information as to the true facts in order that he may intelligently form an opinion. In any case where separate sets of books are kept I think it would be mutually helpful if that fact were made known in connection with the return, and I assume that that is the idea of those who advocated the employment of more than one accounting plan.

My experience with tax consultants has been that they are desirous of giving the full and clear picture of each case, and also that those who have done so have received the utmost of consideration.

Charles W. Gerstenberg: For many years I have been interested in having discussions at meetings of the National Tax Conference that would be of interest in a very definite way to tax payers, and especially to those who have on their shoulders the burdens of seeing that taxes are paid by large organizations.

This round-table finally comes up to my expectations. I am sure that everybody here has been interested and has profited.

We are all grateful to Mr. Fernald for arranging the round-table, and for his conduct of it, and I am sure I express the appreciation of all of us when I say that we are indebted to those who have participated in its discussions.

I trust that in years to come suitable topics will be assigned at each conference, that a group similar to this may always get together, and that it will always be rewarded with the same kind of highly intelligent and profitable discussions.

ROUND TABLE III

The Taxation of Car Lines

Presiding Officer

Irwin Arnovitz, Chairman, Utah Tax Commission

Recording Secretary

Denzel Cline, Associate Professor of Economics, Michigan State College

Participants:

R. C. Beckett, General Attorney, Illinois Central System.

James W. Martin, Kentucky Commissioner of Revenue and Director, Bureau of Business Research, Univ. of Ky.

George A. Kelly, Vice-President, The Pullman Company.

WILBUR K. BUSH, Research Associate, Illinois State Tax Commission

ARTHUR E. BRISTOL, Counsellor at law, Chicago.

C. C. BROWN, Member, Oklahoma Tax Commission.

L. I. TEFFT, Tax Commissioner, Pere Marquette Railway

LOUIS B. DORR, Vice-President-Controller, Jacob Dold Packing Co.

TAXATION OF RAILROAD CARS OWNED BY RAILROAD COMPANIES, AS COMPARED WITH RAILROAD CARS OWNED BY OTHER COMPANIES

R. C. BECKETT

There are about two million railroad freight cars in the United States, of which about one-seventh are owned by companies not owning or operating a railroad.[1]

There are about thirty thousand railroad passenger cars in the United States, of which more than one-fourth are owned by The Pullman Company.[1]

Altogether they represent an investment of some four billion dollars.

The process of formulating and enacting suitable laws and administrative machinery for taxing railroad cars has been slow and sporadic. Although railroads have been operated in this country for more than 100 years, many states have not yet gotten around to providing a comprehensive and adequate method of assessing and taxing railroad cars.

As far as railroad cars owned by operating railroad companies are concerned, perhaps the most usual and simplest plan is to value each railroad system as a unit and apportion a fair proportion of the unit value to each state and taxing district without separate valuation of the rolling stock. This plan is used, for example, in Tennessee, Mississippi, Louisiana, Iowa, Wisconsin, Indiana, and many other states. It has recently been adopted in Illinois under the sponsorship of the learned chairman of the Illinois Tax Commission. It has been sanctioned by the courts in many cases too well known to need citation before this body.

So, also, railroad cars are adequately taxed, without being separately assessed, in states which use the gross earnings tax in lieu of a property tax such as Minnesota, for the gross earnings of railroads are derived from the use of cars as well as roadbed and the two are combined indistinguishably. Under such laws no problems arise as to the adequate and fair taxation of cars owned and operated by railroad companies. And this includes cars held by such

[1] Statistics of Railways in U. S. 1936.

companies under trust agreements and leases for a term of years. For these arrangements are the practical equivalent of ownership for tax purposes.

But many complications have arisen in assessing cars for taxation separately under laws not well adapted for that purpose.

The courts have had a long and arduous struggle to evolve a formula which would (1) preserve the continuity of judicial reasoning, and thereby the dignity of the courts, and (2) permit full and fair taxation of all railroad cars without unduly throttling commerce. In the first place there was the ancient Roman law maxim, *mobilia sequuntur personam.* In the eyes of the law the situs, the legal location of all movable property, was the domicile of the owner. An exception to this rule was in the case of tangible personal property permanently located at a particular place. Its situs for taxation was its permanent location. The rule of taxable situs at place of permanent location made a great breach in the so-called general rule of *mobilia sequuntur personam.*

Although it is said in *Cooley on Taxation*, Fourth Edition, Section 454, "The general rule is that the rolling stock of a railroad company is personal property, and, as such, is taxable to the company in the state of its domicile," and although as late as 1906 the United States Supreme Court allowed New York State to impose a tax on the entire fleet of cars of the New York Central Railroad Company,[2] yet it seems clear in view of later decisions, such as *Johnson Oil Company* v. *Oklahoma*,[3] that the rule *mobilia sequuntur personam* has very little practical application to the present day taxation of railroad cars. The exceptions have swallowed the rule. There is nothing but its tail sticking out.

Next there is the rule, that property in transit cannot be taxed by a state through which it is passing, or merely temporarily resting. The rule itself is an extremely important one, absolutely necessary to the protection of commerce. Without it, seaport cities could levy taxes on, and seize articles of commerce merely passing through such states, and thereby practically levy tribute on the hinterland. Railroad cars are normally, when in use, in transit from one state to another. Railroad cars are habitually in transit. Therefore, in order that cars may be taxed in the states where they are operated, the courts had to evolve an exception to the transit rule, as well as the rule of *mobilia sequuntur personam.*

This was worked out through the rule of *business situs.* Personal property, whether tangible or intangible, can have a business situs different from the domicile of the owner. The business situs of the rolling stock of railroads, as well as the intangibles necessary for

[2] *N. Y. Central* v. *Miller*, 202 U. S. 584 (1906).

[3] 290 U. S. 158 (1935).

their operations, is not a single point, or a series of points, but is distributed over the entire railroad.

The Supreme Court of the United States as early as 1888, said in *Marye* v. *Baltimore & Ohio R. R. Co.*, 127 U. S. 117, 123:

> "It is not denied, as it cannot be, that the state of Virginia has rightful power to levy and collect a tax upon such property used and found within its territorial limits, as this property was used and found, if and whenever it may choose, by apt legislation, to exert its authority over the subject. It is quite true, as the situs of the Baltimore and Ohio Railroad Company is in the state of Maryland, that also, upon general principles, is the situs of all its personal property; but for purposes of taxation, as well as for other purposes, that situs may be fixed in whatever locality the property may be brought and used by its owner by the law of the place where it is found. If the Baltimore and Ohio Railroad Company is permitted by the state of Virginia to bring into its territory and there habitually use and employ a portion of its movable personal property, and the railroad company chooses so to do, it would certainly be competent and legitimate for the state to impose upon such property, thus used and employed, its fair share of the burdens of taxation imposed upon other similar property used in the like way by its own citizens. And such a tax might be properly assessed and collected in cases like the present where the specific and individual items of property so used and employed were not continuously the same, but were constantly changing, according to the exigencies of the business. In such cases the tax might be fixed by an appraisement and valuation of the average amount of the property thus habitually used."

In 1888, in *Pullman* v. *Pennsylvania*, 141 U. S. 18, the supreme court approved a property tax by the state of Pennsylvania on Pullman cars by taking a mileage proportion of the total.[4] The court said:

> "The tax now in question is not a license tax or a privilege tax; it is not a tax on business or occupation; it is not a tax on, or because of, the transportation, or the right of transit, of persons or property through the state to other states or countries. The tax is imposed equally on corporations doing business within the state, whether domestic or foreign, and whether engaged in interstate commerce or not. The tax on the capital of the corporation, on account of its property within the state, is, in substance and effect, a tax on that property."

[4] But see *Union Tank Line* v. *Wright*, 249 U. S. 275 (1919); *Pullman Company* v. *Richardson*, 261 U. S. 330 (1922).

"The cars were continuously and permanently employed in going to and fro upon certain routes of travel. If they had ever passed beyond the limits of Pennsylvania, it could not be doubted that the state could tax them, like other property, within its borders, notwithstanding they were employed in interstate commerce. The fact that instead of stopping at the state boundary, they cross that boundary in going out and coming back, cannot affect the power of the state to levy a tax upon them. The state, having the right, for the purposes of taxation, to tax any personal property found within its jurisdiction, without regard to the place of the owner's domicile, could take the specific cars which at a given moment were within its borders. The route over which the cars travel extending beyond the limits of the state, particularly cars may not remain within the state; but the company has at all times substantially the same number of cars within the state, and continuously and constantly uses there a portion of its property; and it is distinctly found, as a matter of fact, that the company continuously, throughout the periods for which these taxes were levied, carried on business in Pennsylvania, and had about one hundred cars within the state."

"The mode which the state of Pennsylvania adopted, to ascertain the proportion of the company's property upon which it should be taxed in that state, was by taking as a basis of assessment such proportion of the capital stock of the company as the number of miles over which it ran cars within the state bore to the whole number of miles, in that and other states, over which its cars were run. This was a just and equitable method of assessment; and, if it were adopted by all the states through which these cars ran, the company would be assessed upon the whole value of its capital stock, and no more."

Ten years later came the decision in *American Refrigerator Transit Company* v. *Hall*, 174 U. S. 70, where the court sustained a tax on the plaintiff company in Colorado on the average number of cars habitually used in that state. Quoting from an earlier case, the court said:

"Doubtless there is a distinction between the property of railroad and telegraph companies and that of express companies. The physical unity existing in the former is lacking in the latter; but there is the same unity in the use of the same elements of value arising from such use. The cars of the Pullman Company did not constitute a physical unity, and their value as separate cars did not bear a direct relation to the valuation which was sustained in that case. The cars were moved by railway carriers under contract, and the taxation of

the corporation in Pennsylvania was sustained on the theory that the whole property of the company might be regarded as a unit plant, with a unit value, a proportionate part of which value might be reached by the state authorities on the basis indicated."

In that case the court said the refrigerator company was engaged in the business of furnishing refrigerator cars to railroads and shippers on a rental basis.

Minnesota taxes railroads and car lines by a percentage of their gross receipts, in lieu of all other taxes. This method of taxation has been sustained as long as the resulting tax does not exceed a just equivalent of an ordinary property tax.[5]

> "The receipts of the railroads from shipments carried in these cars in Minnesota, less the compensation or rental paid to the company, are added to the other gross earnings of the railroads from business in the state and the total is taken as the value for purposes of taxation of the property which the railroads own or operate in the state for railway purposes."
>
> "In so far as the property constituting this car line is regularly or habitually used or employed in Minnesota it is within the taxing power of the state, although chiefly devoted or applied to interstate transportation."
>
> "Of course, if it is laid on the earnings as such, they being derived largely from interstate commerce, it is an unconstitutional restraint or burden on such commerce and void. *Fargo* v. *Michigan*, 121 U. S. 230; *Philadelphia & Southern Steamship Co.* v. *Pennsylvania*, 122 U. S. 326 *Galveston, Harrisburg & San Antonio Ry. Co.* v. *Texas*, 210 U. S. 217. On the other hand, if what is done is to reach the property and not to take the gross earnings, the latter being taken merely as an index or measure of the value of the former, it well may be that the objection urged against the tax is untenable; for, as this court has said, 'by whatever name the tax or taxes may be called that are fixed by reference to the value of the property, if they are not imposed because of its use in interstate or foreign commerce, and if they amount to no more than would be legitimate as an ordinary tax upon the property, valued with reference to the use in which it is employed, they are not open to attack' as restraining or burdening such commerce. *St. Louis Southwestern Ry. Co.* v. *Arkansas*, 235 U. S. 350, 367; *Postal Telegraph Co.* v. *Adams*, 155 U. S. 688; *Wisconsin & Michigan Ry. Co.* v. *Powers*, 191 U. S. 379, 387; *Fargo* v. *Hart*, 193 U. S. 490, 499; *Galveston, Harrisburg & San Antonio Ry. Co.* v. *Texas, supra.*"

[5] *Cudahy Packing Co.* v. *Minnesota*, 246 U. S. 450 (1918).

> "The question of the nature and effect of taxes more or less like this has been repeatedly considered in this court. In some instances its solution has been attended with considerable difficulty, for while the controlling general principles have long been well settled it has not been easy to apply them to all the varying situations presented."
>
> "Because of the usual tax rate, if applied to the cash value of the cars taken separately, would result in an appreciably lower tax, it is insisted that the tax imposed is in excess of what would be legitimate as an ordinary tax on the property. But the contention proceeds on an erroneous assumption. The state is not confined to taxing the cars or to taxing them as separate articles. It may tax the entire property, tangible and intangible, constituting the car line as used within its limits, and may tax the same at its real value as part of a going concern. The record makes it reasonably certain that the property, valued with reference to its use and what it earns, is worth considerably more than the cash value of the cars taken separately—enough more to indicate that the tax is not in excess of what would be legitimate as an ordinary tax on the property taken at its real or full value."

It will be observed that all these cases sustaining taxes on the car line companies speak of property "regularly and habitually used in the state."

A recent case is *Johnson Oil Company* v. *Oklahoma*, 290 U. S. 158 (1933). There the Johnson Oil Company, an Illinois corporation, owned a fleet of tank cars operating mainly to and from its refinery at Cleveland, Oklahoma. They were all stenciled "When empty return to Johnson Oil Refining Co., Cleveland, Oklahoma." Admittedly the cars were not taxed in Illinois. Oklahoma tried to tax them all as having their business situs in that state. The supreme court said:

> "The cars are almost continuously in movement."
>
> "Appellant had its domicile in Illinois, and that state had jurisdiction to tax appellant's personal property which had not acquired an actual situs elsewhere. 'The state of origin remains the permanent situs of the property notwithstanding its occasional excursions to foreign parts.' See *New York Central & H. R. R. R. Co.* v. *Miller*, 202 U. S. 584, 597; *Southern Pacific Co.* v. *Kentucky*, 222 U. S. 63, 69. But the state of the domicile has no jurisdiction to tax personal property where its actual situs is in another state."
>
> "The jurisdiction of Oklahoma to tax property of this description must be determined on a basis which is consistent with the like jurisdiction of other states.

> The basis of the jurisdiction is the habitual employment of the property within the state. By virtue of that employment the property should bear its fair share of the burdens of taxation to which other property within the state is subject. When a fleet of cars is habitually employed in several states — the individual cars constantly running in and out of each state— it cannot be said that any one of the states is entitled to tax the entire number of cars regardless of their use in the other states. When individual items of rolling stock are not continuously the same but are constantly changing, as the nature of their use requires, this court has held that a state may fix the tax by reference to the average number of cars found to be habitually within its limits."

It will be seen from the cases mentioned above that it is now well settled that the unit of a railroad system, including its entire fleet of rolling stock, is taxable in the states in which its railroad is operated, the entire value being apportioned between those states; that in many states the value of all the cars and locomotives is assessed as part of the roadbed and this has been approved by the highest courts. On the other hand, the cars of a car line company, whether engaged in the business of operating or renting cars as the Pullman Company, or the Union Tank Line, or whether using cars mainly as an incident to its own business as in the Johnson Oil Company case or the Cudahy Packing Company, form a unit with a situs extending over all states in which such cars are habitually employed. In other words, the taxable situs of cars owned by an operating railroad company is limited to the tracks of that company, regardless of the movements of the individual cars in interchange with other railroads, whereas the taxable situs of cars of private car line companies extends to all states where such cars go in the course of the business of the owner.

The reasons for this difference are historical and practical. Historically, the taxation of railroad companies has developed in such a way that under all systems of taxing them in the various states their cars are fully taxed as part of the owning company's railroad system, prorated only over the states in which that company operates. Since the situs of railroad cars has "jelled" in that way, the field is fully occupied, their value is fully taxed under existing approved systems, and any attempt of other states to tax foreign railroad-owned cars found within its borders would be a violation of a settled theory of actual situs. It would violate the statement of the court in the Johnson Oil case, that "The jurisdiction of Oklahoma to tax property of this description must be determined on a basis which is consistent with the like jurisdiction of other states." Coal cars of the Norfolk & Western Ry. may come to Chicago just as frequently and regularly as tank cars of the Union

Tank Line, but the jurisdiction to tax the coal cars of the Norfolk & Western has been preempted by the states in which that company operates its tracks.

When the courts broke through the maxim *mobilia sequuntur personam*, and the exemption of property in transit, the situs of taxation of railroad-owned cars spread and "jelled" at the limits of the railroad system.

As to private cars, however, when the situs broke away from the domicile of the owner, there was no stopping place short of spreading over the entire area of movements of each car in the course of the business of its owner.

And so when in 1926 the tax authorities of the state of Kentucky attempted to tax cars of the Union Pacific, the Santa Fe, and other railroad companies, which happened to be found within Kentucky, the supreme court of Kentucky in *Commonwealth* v. *Union Pacific R. R. Co.*, 214 Ky. 339, 283 S. W. 119, held that Kentucky had no jurisdiction to tax them. In a very interesting and well-reasoned opinion the court said that railroad cars, whether belonging to a railroad company or other companies, form a unit which may be compared to a hive of bees. Individuals change but the hive remains the same. The "hive" of a railroad company extends only over its own rails without regard to occasional movements beyond occasioned by the interchange of cars of the railroad companies.

On the other hand, the hive of private car lines extends over the entire territory in which they operate since the business of the owners consists in operating,[6] or renting,[7] the cars, or transporting its own products in them.[8]

During the last two or three years the tax commissions of Florida and Oklahoma have attempted to tax foreign railroad cars found in their states, but in both cases the proposed assessments were withdrawn after conference with the carriers.

As a practical matter, no state would gain anything if the theory of the situs of railroad-owned cars should be changed so as to give them a broader situs. If such a change were made, each state, before taking its proportion of the cars of a railroad system, would have to make allowance for a large percentage of the cars being found at any given time in foreign states. What any state would gain in additional taxes on cars of foreign railroad companies they would lose by necessary allowances in fixing the taxes of railroads operating in such state. There would be a great increase in the difficulty and confusion of making correct assessments without any corresponding gain.

[6] E. g., *Pullman Co.* v. *Richardson*, 261 U. S. 330.

[7] E. g., *Union Tank Line Co.* v. *Wright*, 249 U. S. 275; *Union Tank Line Co.* v. *McKnight*, 84 F 2d, 421 (1936).

[8] E. g., *Cudahy Packing Co.* v. *Minnesota*, 246 U. S. 450.

APPLICATION OF UNIT RAILROAD ASSESSMENT BASIS WHERE SUBSIDIARY LINES, LEASED LINE, AND TRACKAGE RIGHTS ARE INVOLVED

JAMES W. MARTIN

The definition of unit assessment where subsidiary lines, leased lines, and trackage rights are involved is a twofold problem. In the first place, it is a problem of the inclusiveness of the "unit." For example, shall the assessment be made on the corporation as such, or on the system as such, or shall some intermediate unit be selected? In the second place, which method of allocation will operate fairly with respect to a particular railroad in which some or all of these diverse arrangements exist?

What Constitutes a "Unit"[1]

Assuming that the unit method of assessment is to be adopted, either because it is required by law or because it is desirable as a matter of assessment policy, the problem of whether or not properties operated by subsidiary corporations should be included as an integral part of the assessment unit must be answered before any assessment can be made. The statutes in the various states differ considerably on this point, and evidence available indicates that a good deal can be said for various approaches to a solution of this problem. The statute in Kentucky contemplates a policy of including subsidiary corporations; and, as interpreted, it appears to require that, for franchise tax purposes at least, the entire operating entity be included and that no lines owned, leased, or controlled be eliminated unless they are substantially severed from the operating lines in Kentucky. It is to be observed that the restrictions in this respect apply exclusively to the franchise tax, which is essentially a tax on corporate excess, and that any method which is constitutional can be employed in Kentucky in the assessment of tangible properties. As a matter of simplicity, however, the practice is, and for many years has been, that the same operating entity is made the basis for allocation of all the properties of the corporation. Thus, if subsidiary corporations are intimately associated with the parent corporation having properties in the state, the entire system, whether owned by one or by several corporations, is made the assessment unit. Because the courts have emphasized the stock and bond method of assessment and because as a practical matter the employment of that method is desirable, the inclusion of as much of the system as is legally possible is to be desired.

[1] T. S. Adams, "Valuation of Railway Property for Purposes of Taxation," *Journal of Political Economy, January*, 1915, pp. 1 ff., is a little classic on this general subject. (It must be read in the light of its age.)

Inclusiveness provides a means of eliminating the necessity for deducting non-operating intangible property, and thereby simplifies the valuation procedure and renders more accurate the application of the stock and bond method.

Much the same line of argument applies to leased lines. The theory of unit assessment is essentially one which involves the employment of the operating entity rather than of the ownership unit in the legal sense in arriving at the aggregate value of the property to be assessed. As Professor Bonbright effectively puts the matter: "The whole spirit of the unit rule seems to me to require that functional rather than titular relationships be given dominant importance."[2] For the reason indicated, where the unit rule is employed it is necessary as an assessment procedure to treat a leased line exactly as though the operating carrier owned it.[3]

In respect of trackage rights, it must be noted that the terms of various contracts differ substantially. It must be observed also that the owning railroad will be required to pay taxes on account of trackage owned and operated and that, consequently, out-right assessment against an operating carrier of property used under trackage rights will mean partial duplication. The contracts under which the right to the joint use of tracks arises normally result in an increase in the value of the property; and to the extent of the increase there would be no duplicate levy. In the light of this situation, therefore, it appears that for certain purposes the unit should include trackage rights and for other purposes it should not. I conceive this problem to be susceptible of solution in terms of an allocation principle rather than in terms of the definition of the unit. In employing stock and bond or capitalized income methods of valuation, clearly, neither the income from operations under trackage right contracts nor any element of property reflected in the stocks and bonds should be eliminated from the picture.

It may be said in substance, therefore, that the definition of the assessment unit must be couched in terms of an operating entity; and, despite the impediments introduced by intercorporate complexities, the assessing process should look as far as possible to the valuation of the operating unit. This conception of the problem is essential, not only to the definition of the unit which is to be allocated, but also to a clear-cut understanding of the allocation of interstate carriers to the individual states. One specific problem to which most of the state statutes make the application of this theory impractical except by agreement is introduced where the only property operated in the state is owned by a subsidiary corporation. Under many of our state statutes it is probably invalid to employ

[2] James C. Bonbright, personal letter of September 19, 1938.

[3] Until I initiated certain correspondence with railway tax officials I had assumed that all of these officials would agree with this conclusion. It appears, however, that a minority of them do not.

the operating entity as a valuation basis under such circumstances. There is, however, comparatively little danger to good assessment practice; since the operating entity, so far as the state involved is concerned, may be in a fundamental economic sense the subsidiary corporation alone. It is observed, however, that despite the regulations incident to railway accounting there is still some possibility of distorting the income picture for individual subsidiaries to the advantage of other lines in the system. For the most part, under current operating conditions this problem is not serious.

The Theory of Allocation Incident to Unit Assessment

The theory of unit assessment in the case of an interstate carrier is predicated on the assumption that the value subject to tax in any one state does not of necessity, or even normally, represent the fair market value of the distinctive parcels of property situated in that state. As a practical matter, the value of the property assessed for state tax purposes does not normally, and need not necessarily, conform with the separate property in the state. Legally as well as economically, practically the entire value of certain railroads could be destroyed by eliminating even a few miles of line from one state. It would not be contended as a consequence that these few miles made up the entire value of the road. An illustration perhaps will make the point clear. The CNO & TP Railroad operates a line between Cincinnati, Ohio, and Chattanooga, Tennessee. This is a particularly profitable enterprise. If, however, the railroad should have a mile of line destroyed at some point in Kentucky the value of the system would be virtually eliminated, although undoubtedly the most valuable miles of line of this carrier are situated at the terminal points indicated. Therefore, the theory of allocation of a unit assessment is that the allocation shall be reasonable and shall reflect the elements in the situation which have to do with the value of the line itself. For this reason not only the cases handed down by the courts but also the literature reporting independent economic studies of the problem agree that two or more allocation factors reflecting physical property and two or more allocation factors reflecting operating experience shall be utilized in arriving at a fair allocation. There is no pretense on the part of realistic economists that the value actually allocated is the separate value in the state; it is rather simply a reasonable share of the aggregate value of the operating entity.

In conformity with this theory, as indicated above, mileage owned by subsidiaries and mileage leased from other lines must, if they are part of the operating entity, be treated exactly as mileage directly owned by the parent operating corporation. The application of the four-, five-, six-, or sevenfold allocation formula to the

entire mileage, consequently, must include all mileage owned, leased, or controlled through ownership by subsidiaries to the extent that such mileage is a part of the operating unit subject to assessment.

It is apparent that a special plan of allocation must be devised for railroads having a substantial mileage of trackage rights. Such a plan will take into account factors reflecting operations, but not factors reflecting property ownership. Moreover, the plan must be so integrated that it will be comparatively easy to understand, and so formulated that its theoretical implications are clear.

A Plan for the Allocation of Railway Properties under Varying Circumstances

The general allocation formula can be employed only when there is sufficient mileage of diversified character, both in and out of the state, that its elements fairly represent the elements in the specific situation involved. For example, if a railroad owns in a given state only terminal and closely related property, the general allocation theory may have to be radically modified and specific, separate plans may be required in order to obtain an approximation of fairness. For this reason such operating conditions may be regarded as definitely excluded from the purview of the following discussion. In other words, the allocation plan suggested below for application to subsidiaries, leased lines, and trackage rights will be understood to apply only where the carrier has a considerable amount of mileage operated under comparatively diversified conditions to justify employment of the general allocation formula.

The allocation formula most frequently recommended by unbiased students and expressly approved as a matter of law is one which involves, as has been suggested, certain operating and certain physical property elements. Owing to this circumstance, the formula used in Kentucky includes two operating factors, namely, traffic units and allocated gross receipts, and two property elements, namely, all-track mileage and reproduction cost new plus net additions at cost. In view of legal restrictions on the kind of trains used, it occurs to me a car mileage factor might be included among the operating criteria; but we do not include such a factor in Kentucky, largely because it would complicate, without greatly altering, the facts of the situation. It may be said parenthetically that for one formal purpose, due to our statutory plan, line mileage is introduced as a fifth factor. There seems to be no good reason why property and operating elements in the formula should be given different weight.

With respect to subsidiary mileage and leased lines, as has previously been indicated, the allocation formula should be applied exactly as to mileage owned and directly operated. This is the practice in Kentucky, and apparently in all states which have given serious consideration to assessments of railroads and which

employ the unit method. If the theory stated above is sound, there is no reason whatever for differentiating mileage owned, leased, or controlled through ownership by a subsidiary in applying the general allocation formula.

When it comes to mileage operated under trackage rights, however, the situation is different. The sound procedure in such an instance seems to be that of assessing against the carrier enjoying trackage rights the physical property it actually owns and assessing against the line which owns the trackage the property it owns. Therefore, in the allocation formula, which seeks to allot to the state its fair share of the unit value of the operating whole, the physical property elements in the allocation formula should not be applied to trackage operated under trackage rights but only to other mileage. On the other hand, in employing the formula the traffic units and the gross receipts derived from transportation over track owned and operated by another carrier should be included in the allocation formula, so that the added value due to operation over such mileage will be reflected in the share of the total property of the carrier in the assessing state.

Thus, a carrier owns 100 miles and leases 50 miles in Kentucky; it has trackage rights over an additional 25 miles. This carrier's property having been valued as a unit, it will have allocated to Kentucky an amount arrived at by including all mileage owned, leased, or controlled through subsidiaries in all-track mileage. In this figure it will have excluded from the allocation formula the 25 miles of trackage as well as the reproduction cost of that mileage; and there will be likewise excluded in computing both of these factors the operating mileage out of the state which is handled under trackage rights. On the other hand, the gross receipts from the entire 175 miles and the total passenger miles and freight ton miles over the entire 175 miles will be included in the gross receipts and the traffic units within the state.

By following this plan the road having a large amount of trackage rights either in the state or out of the state will be fairly treated. The general theory is also reconciled with the fundamental underlying principle which unit assessment originally involves.

SITUS OF PROPERTIES OF CAR COMPANIES FOR PURPOSES OF STATE TAXATION

GEORGE A. KELLY

In practically every state there are now statutory provisions requiring a designated state agency to fix a taxable value of the properties of car companies based on the full cash value of such properties, having a taxable situs in the state. Seldom, if ever, do we find statutory directions as to how the full cash value should

be determined—so, it is within the discretion of the various assessing agencies to give consideration to such approved and recognized factors as may assist them in arriving at the full cash value of such properties for tax purposes. Without stopping to discuss the various permissible methods, factors and elements which may be used in arriving at value, let me emphasize that fundamentally, in valuing car lines property for taxation, the value of the utility in the state is the thing sought. Many years ago Mr. Justice Brewer said: (*Ry. Co.* v. *Backus* 154 U. S. 439).

> "The rule of property taxation is that the value of the property is the basis of taxation. It does not mean a tax upon the earnings which the property makes, nor for the privilege of using the property but rests solely upon the value. But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and profitable character of such use determines the value, and if property is taxed at its actual cash value it is taxed upon something which is created by the uses to which it is put."

But, in all of the states, the only property of car companies which may be valued and assessed, is property having a situs in the state. The general rule is to the effect that rolling stock is personal property, and as such, is taxable to the owner in the state of its domicile. But it is also generally held that such property may acquire a taxable situs in such other states, where it is more or less continually used, provided there is no unlawful interference with interstate commerce.

No state has jurisdiction to tax car companies' property located beyond its borders, nor cars which never enter the state, nor cars which occasionally and temporarily come from another state or pass through the state in commerce between the states. But, any state may lawfully tax the fair proportion of the company's cars which habitually and customarily are operated over lines which pass into, through, and out of the state, and at a valuation not merely as separate articles, but as part of the car line of which they are a constituent part. But this, I submit, gives the extreme limit to which any state may lawfully go in taxing such cars. While the state may lawfully tax a proportion, fairly ascertained, of the cars used on lines of railroad passing, into, through, and out of the state, it cannot tax any cars which never enter the state and which are used exclusively on other separate and independent lines, which do not touch the state; and while it may lawfully so tax such proportion of cars, it cannot for the purpose of increasing the value of such proportion, treat the foreign cars which never enter the state as any part of the car lines which touch the state, because

such foreign cars are operated in separate and independent car lines, and are neither physically nor functionally connected in any way with the cars used in lines which touch the state, and no part of the value of such foreign cars, tangible or intangible, can be allocated to the state by any device whatsoever.

Many years ago, the supreme court (*Pullman* v. *Penn*, 141 U. U. 18) said:

> "The mode which the state . . . adopted to ascertain the proportion of the company's property upon which it should be taxed in that state, was by taking as a basis of assessment, such proportion of the capital stock of the company, as the number of miles over which it ran cars within the state bore to the whole number of miles in that and other states over which its cars were run. This was a just and equitable method of assessment, and if it were adopted by all the states through which these cars were run, the company would be assessed upon the whole value of its capital stock, and no more."

For many years, the decision in this case was referred to and cited by the courts as the controlling precedent in the application of the so-called unit rule. It was not until the case of *Union Tank Line* v. *Wright* 249 U. S. 275, decided March 24, 1919, that the court repudiated and overruled the language, above quoted, when the assessing officer in the Union Tank Line case, relied upon this language to sustain his assessment, the court said:

> "But the point therein spoken of was unnecessary to determination of the cause; and so far as the quoted passage sanctions the specified rule for ascertaining values as generally appropriate, just, unobjectionable and productive of conclusive results, it must be regarded as *obiter dictum* and we cannot now approve or follow it."
>
> "In other opinions of this court, we upheld the power of a state to tax property actually within its jurisdiction upon a fair valuation considered as part of a going concern, but they give no sanction to arbitrary and inflated valuations. Taxes must follow realities, not mere deductions from inadequate or irrelevant data."

This discredited *obiter dictum* also inspired the decision of the court in *Adams Express Co.* v. *Ohio* 165 U. S. 194, 166 U. S. 185, where by a divided court, 5 to 4, the majority maintained the proposition that the unit rule of valuation, theretofore applied only to *railroad or telegraph lines which had a physical unity*, could lawfully be extended to express companies engaged in interstate business, by reason of the so-called "unity of use," although there was no physical unity between their parts. The majority, after citing several cases involving the application of the unit rule to railroads

and telegraph companies, based its ruling on *Pullman* v. *Penna.*, now overruled and discredited as I have stated. And the majority were misled by that dictum, notwithstanding the minority of the court clearly pointed out that the dictum was *obiter* and in their opinion not sound. (Dissenting Opinion 165 U. S. at page 249, 250, 251, 252, and petition for review in same case, 166 U. S. page 211.)

The underlying principle of Mr. Justice White's dissenting opinion, became the underlying principle, afterwards adopted by the court, upon which *Fargo & Hart*, 193 U. S. 490, was decided. Surely, the keystone of the decision in *Adams Express Co.* v. *Ohio* (165 U. S. 277) has been greatly shaken, even if that case has not been expressly overruled. It is well that its authority has been shaken and that its scope has been limited by the decision in the Union Tank Line case, as well as by later decisions, to which I could refer, if time permitted; because under the unit rule of apportionment apparently so broadly sanctioned by the opinion of the majority of the court in that case. Zealous tax assessors have made predatory excursions beyond their territorial jurisdiction and have unlawfully burdened interstate commerce. Under this system, assessors do not merely overvalue property within their jurisdiction; they reach out and grasp elements beyond it, and impute these to the ostensible subjects of their assessments.

The extreme lengths to which assessors have attempted to go under the supposed sanction of this express company case, are well illustrated in *Standard Oil Co.* v. *Howe*, 257 Fed. 481, and the *Nevada-California Power Co.* case, 235 Fed. 317; 240 Fed. 485; 264 Fed. 643. It should be noted, however, that the majority opinion in the express company case concedes that the unit rule there approved, is not of universal application.

In the majority opinion, the following important concession is made:

> "We repeat that while the unit which exists may not be a physical unity, it is something more than a mere unity of ownership. It is a unity of use, not simply for the convenience or pecuniary profit of the owner, but existing in the very necessities of the case—resulting from the very nature of the business.
>
> "The same party may own a manufacturing establishment in one state and a store in another and may make profit by operating the two, but the work of each is separate. The value of the factory in itself is not conditioned on that of the store or vice versa, nor is the value of the goods manufactured and sold affected thereby. The connection between the two is merely accidental and growing out of the unity of ownership. But the property of an express company distributed through

> different states is as an essential condition of the businesss united in a single specific use. It constitutes but a single plant, made so by the very character and necessities of the business."

The significance of this concession and limitation of the unit rule appears when it is read in connection with the dissenting opinion, 165 U. S. pp 250 to 254, which emphasizes this limitation.

In the cases since decided in which the unit rule of valuation and apportionment has been recognized there was *in fact* an actual unity of use, and not a mere unity of ownership and management of properties not functionally connected. In such cases, the cars were used indiscriminately to produce one result and all functioned together so that there was unity of use.

But, where specific cars are assigned to independent railroads under separate contracts for exclusive use on certain lines and not elsewhere, and these specific lines have no physical or functional connection or other relation than that of ownership, then only those states which are touched by these lines, may lawfully tax its fair proportion of these cars. Additionally, there are instances where all cars owned or all cars in service, can not be used indiscriminately everywhere, because cars of certain types of construction have been legislated off of certain lines.

Another limitation of the unit rule is that if the total value includes the value of properties not equally applicable to all the states in which the business is conducted, that is, where by reason of special circumstances property in one state is proportionately more valuable than the property in another state, then the total value cannot be apportioned on a mileage basis.

Thus, cars used and business done on lines which touch one state, may have neither physical connection nor organic or other relation with the property and business of the company done on other lines, save and except such relation as grows out of the fact that the company is the owner and manager of all such properties. There may be no continuity of passage or connection between lines which touch one state and those lines which do not. Certain specific cars may be and are set apart and temporarily assigned for service on separate lines which function independently of any other line.

The relation of ownership and management of cars and property used on separate and independent lines is totally different from the relationship of miles of railroad or telegraph lines extending into several states, but all physically connected and used for one purpose and to produce one result. So, also is such relation of ownership and management, different from the "unity of use," so-called of the properties of an express company used in several states; for instance, the express agent and horses and wagons in New York City which collect the express packages from the consignor and take them to the express company to be carried, are connected with the express agent, horses and wagons in Ohio, which receive and

deliver the package to consignees in Ohio. They are necessarily dependent on each other, and neither can function separately; there is "unity of use." But, the relationship of ownership and management of disconnected cars and property used on separate and independent lines, which do not function together, is not such "unity of use" as justifies the application of the unit rule of valuation and apportionment upon a mileage basis; it is no more than unity of ownership and management for the convenience and profit of the owner, which as I have stated neither justifies nor permits the application of the unit rule.

Certainly, as the court said in *Wallace* v. *Hines*, it cannot "be seen in any plain and intelligible way," how cars which never enter a particular state and are used exclusively elsewhere and are not functionally connected with the cars which do enter the particular state, contribute any of their value to the cars used in lines which touch the state.

The court also said in this case, (*Wallace* v. *Hines*, 253 U. S. 66):

> "The only reason for allowing a state to look beyond its borders when it takes the property of foreign corporations is that it may get the true value of the things within it, when they are a part of an organic system of wide extent, that gives them a value above what they otherwise would possess. The purpose is not to expose the heel of the system to a mortal dart —not, in other words, to open to taxation what is not within the state."

Notwithstanding such clearly expressed guides and admonitions for the application of the unit rule, some states are prone to go beyond the borders of their states and subject to taxation property not within their jurisdictions. In doing this, or seeking to do so, they go to unwarranted extremes, in requiring, under broad statutory powers, the furnishing of much extraneous, irrelevant and useless information, which imposes upon the car owner, unjust and unnecessary expense, and, occasionally, unjust and illegal taxes, which are less costly to pay, than to litigate.

OPERATION OF THE 1937 RAILROAD LAW IN ILLINOIS IN THE ASSESSMENT OF PRIVATE CARS

WILBUR K. BUSH

Legal History of Car-Line Assessment

The property of private car lines in Illinois has been subject to local assessment to the owners since 1873. Prior to this time rolling stock owned by other than railroad companies was assessed to the railroad operating the same. This procedure was verified by the Illinois Supreme Court in 1869 in *Kennedy* v. *St. Louis and*

Vandalia R. R. Co. 62 Ill. 395 where cars of the Pullman Company were assessed to the using railroad.

Prior to 1869 the phrase "belonging to" had been interpreted in *Cook County* v. *C. B. & Q. R. R. Co.* 35 Ill. 461 as exclusive of leased rolling stock. The 1869 amendment was interpreted in the Kennedy case as including *all* used equipment. After this date car-line property was generally subject to local assessment. It has remained in this category until the present time. Now, however, in accordance with the enactment of a railroad law in Illinois in 1937 and the ruling of the Illinois Supreme Court in *People* v. *Wilson Car Lines, Inc.* 369 Ill. 295, there has been a recognized shift in the assessing authority from the local assessors to the state tax commission. Section 2 of this law states that "the tax commission shall assess all property owned or used by railroad companies" with the exception of non-carrier real estate. The word "used" in this connection was interpreted by the supreme court to transfer liability for the assessment of car-line property to the tax commission and for the reporting thereof to the railroads. The hauling of cars in the transportation of freight, even though the railroad has no specific control over the car other than through routing from shipper to destination, is presumed to constitute use under the present railroad law.

Assessment Procedure

In conformance with the dictum of the supreme court, the tax commission is assessing the cars in Illinois owned by private car lines to the railroad companies using such property. To enable a proper valuation to be made on the basis of information which could be furnished by railroad companies, there was required of all railroads operating in Illinois information as to (1) the total car mileage hauled in Illinois for each non-railroad company owning private cars haued by the railroads, (2) total compensation paid to such companies for the mileage made in Illinois over the track of each railroad, (3) the total car mileage made over the system lines of the reporting railroad and (4) the compensation paid for the total system mileage made over the lines in Illinois and all other states in which operations were conducted. From this information it became necessary to rationalize on the probable daily car mileage of the equipment involved to ascertain, by equipment types, the number of cars which were allocable to Illinois, and to develop average car values to be placed on various types of equipment.

Car Values—Owing to the fact that it is assessing property reported by agents and is not in position to require information not in the hands of the railroad concerning private cars, the commission has aimed to establish conservative valuations with the end of limiting the scope of any litigation which might arise from the prevail-

ing interpretation of the meaning of the word "use" in the railroad law to matters of jurisdiction, not of valuation. With this fact in mind a survey was made of the average car values reported in the description of underlying security of equipment obligations. In this connection only the more recent equipment security flotations were used. This was done in order to make sure current reproduction cost figures were obtained. Had equipment values found in some of the older equipment trust issues been used, an anachronistic set of cost of reproduction prices might have led to an unrealistic result. A consideration in the use of values set forth in equipment trust issues is the fact that the equipment values there shown would probably be at a maximum within a given range of judgment, owing to the need for maximum security. However, it was generally presumed that statements relating to cost of equipment should be taken approximately as actual new value.

Per Cent Condition—The second problem to be met was the establishment of conservative per cents of condition for various types of equipment. The available information on this score was extremely erratic and not nearly so reliable as the cost figures shown in the underlying security for equipment trust issues. An analysis was made of the equipment costs shown on the balance sheets of the leading car loaning organizations. Full account was then given to accrued depreciation set up on the books of these companies and the net figure was deemed to be the best judgment of the accountants of the car loaning companies as to the depreciated book value of their equipment. These ratios varied widely between companies and also between types of equipment. In the interest of arriving at conservative valuations, it was decided to use a per cent condition sufficiently beneath those found by the above method generally to forestall any criticism on this score. The application of the per cent condition so found by the commission to the car values resulted in a figure purporting to show the full value of the average car in each of several equipment classes; i. e. refrigerator, tank, etc. It was discovered that refrigerator cars are more expensive than tank cars, and tank cars in turn more expensive than some of the less familiar classes of privately-owned railroad rolling stock. With reference to the relative car mileage of various classes of equipment and the various sets of performance statistics available, it is then possible to allocate the total number of cars found to be assignable to Illinois into the several types for which separate unit equipment values were found.

It was observed that the greatest diversity of ownership occurred in the tank car classification, whereas the largest car mileage was found to exist in the refrigerator group. This suggests that there may be wide variations between the car mileage made by various equipment groups. It will be necessary to take this into account in order to make the most accurate ownership distribution of the equipment assigned to Illinois.

Use of Gross Earnings — In states having car-line statutes it is probably feasible, depending upon the particular statute, to take some account of earnings in the assessment of private cars. It was found for example, that the gross revenues of private cars operating in Illinois would approximately equal the depreciated values which might be arrived at from a cost of reproduction point of view. This in itself indicates that private cars are approximately five times as productive as railroad property generally in the creation of gross revenues and it is reasonably certain to infer that this same relationship is true in any discussion of net income. In Illinois it is contemplated no weight will be given to the earning power of private cars in arriving at values such as might be done if a specific statute were in effect for car-line companies, providing that the earning power of such property be examined in addition to its depreciated cost of reproduction. Using depreciated cost of reproduction as a basis for assessment probably yields tax revenue which, when compared with gross revenues, will be a much smaller percentage than many states now obtain through gross earnings taxes on this class of property. It is fairly apparent that most car-line companies can show annual gross revenues in excess of the depreciated value of the property. The move the commission has adopted, it is felt, however, will mitigate the legal vulnerability of the assessment from a valuation point of view.

History of Assessment in Illinois

The problem of assessing property of as transitory a nature as private cars presents virtually insurmountable obstacles to the local assessor. Prior to the enactment of the railroad law and this attempt to assess the equipment of private car-line companies, these problems have been typical in Illinois. So far as ascertainable, there are not over three or four counties out of 102 in the state, which have been successful in the assessment of this class of property. Owing to the fact, of course, that it is difficult for the local assessor to establish or even claim situs for equipment which passes through his county, the practical effect of local assessment was to enable the equipment of private car-line companies to be operated in Illinois and pay only an infinitesimal part of its probable total tax burden. This has been in the nature of subsidizing the operation of this equipment, owing to maladjusted administrative techniques. The problem has been accentuated by the fact that the mileage tariffs paid to private car-line companies by the railroads are set at mileage rates which are sufficiently large to include an amount to compensate the private car-line company for repairs, depreciation, operating expenses and taxes. This has led certain of the railroads to suggest that the new attempt to assess private car lines results in double taxation because of the fact that the present day tariffs purport to include an amount for taxes. The

record of assessment in Illinois, however, indicates that in most counties virtually no personal property taxes are paid in Illinois on private cars. There is no equity in permitting this type of property to escape taxation when the administrative technique is at hand to put an end to this subsidy.

Under the present assessment set-up in Illinois cars habitually at rest in a county at repair points are subject to local assessment. Cars making mileage over railroad lines will be state-assessed. The objection to this procedure most frequently raised is that because a car may be idle at a repair point for a portion of the year and hauled by railroads for the balance, it is put into two categories and assessed by both the state and the local assessor. In such cases an adjustment could be made for cars locally assessed under the interpretation that they are not used by the railroads. To satisfy this requirement, however, it would be necessary to demonstrate the average number of cars which made no mileage at all during the year. This particular difficulty could be circumvented by an allocation to Illinois based on the relative number of days the car was in the state. Such reporting would also take into consideration the demurrage situation which is of secondary importance.

Possible Developments

In pursuing this relatively novel experiment in the assessment of this type of property, it is possible that some testing litigation may be introduced. This would be welcomed as an attempt to put the assessment of this type of property on a sound legal basis in Illinois. The assessment when made will be distributed to the counties on the basis of the all track mileage existent there. As to the collection of the tax, two alternatives appear to be open. One is that the burden of paying the taxes will be placed upon the railroads under a strict interpretation of their use of the property. The second alternative is that the court may decide, inasmuch as the property is reported by the user and not the owner, that any taxes paid by the user may be recoverable from the owner by reason of the laws of assessment of property in the hands of agents.

Arthur E. Bristol, Counsellor-at-Law, Chicago: I have not prepared a formal paper, first, because of lack of time, and second, because the longer I study this subject the less I seem to know about it. Many years ago I thought I knew something about the problem but now it only confuses me. I do not represent a car line company but a shipper that owns its own cars. Do we know just what is the proper meaning of such terms as "car lines", "use", and "operation in a state"? When is a company owning cars used on a railroad a public utility? The Utah commission has agreed that the company I represent is not a public utility.

With respect to taxation, I do know that this company is being assessed today on its cars at about 117 per cent of their value. A tank car is a piece of tangible physical property. I don't see how it can be regarded as anything more. To indicate the existing confusion, again I ask: What is a public utility? What is a car line?

THE GROSS EARNINGS METHOD OF TAXING FREIGHT LINES

C. C. BROWN

There are now five states which use the gross earnings method of taxing freight lines. These states and the rates in each instance are as follows: Connecticut, 3%; Kansas, 2½%, Minnesota, 6%; Oklahoma, 4%; Wisconsin, 6%.

The laws of four of these states—Kansas, Oklahoma, Minnesota and Wisconsin—are very similar and require the railroads to withhold the tax and make remittance direct to the collecting agency. The Oklahoma law differs from that of the other states in that the collecting agency, the Oklahoma Tax Commission, is authorized to raise or lower the rate to conform to what the tax would be if the cars were taxed ad valorem.

It is well established that the gross earnings method of taxing freight lines does not unlawfully burden interstate commerce or violate any provision of the federal constitution, provided the tax is in lieu of the ad valorem property tax and is no greater than the general ad valorem tax would be if the cars were taxed on that basis. (*Cudahy Packing Company* v. *State of Minnesota*, 246 U. S. 450.) Since this has been established the question of whether it is more desirable to tax freight cars on a gross earnings or an ad-valorem basis is one which should be determined primarily by the provisions of the constitution of each individual state.

Quite a few states have constitutional requirements that such property be taxed ad valorem, and the gross earnings method of taxing freight cars has therefore been held to be violative of the state constitution in at least two states—Montana and North Dakota. (*Fruit Growers Express Co.* v. *Brett*, 22 Pac. (2nd) 171; *Montana-North Dakota* v. *Weeks*, 8 Fed. Sup. 935.) Such states are therefore forced to tax freight cars on an ad-valorem basis, but may choose between local and central assessment.

Those states which have central assessment have adopted one of the following methods of levying and apportioning the tax:

(a) A state levy comparable to the average ad-valorem rate for all purposes.

(b) Allocation of the valuation to the local taxing districts through which the cars are operated, with the same levies as are applied to other property in such districts.

(c) Allocation of the entire valuation of each company to one taxing district.

From an administrative standpoint, the first method is the most desirable, but several states, including Oklahoma, are prevented from using it by constitutional provisions limiting or prohibiting ad-valorem levies for state purposes, and prohibiting the state from levying taxes for purely local purposes.

The second method is the most equitable, but is very burdensome, both to officials and taxpayers, because of, (a) the difficulty in determining just what taxing districts the cars of a given taxpayer were operated in or through, and the comparative density of operation in such districts, and (b) the requirement that a very small valuation and tax must frequently be spread over a large number of counties and subdivisions. This method is also objectionable because of the difficulty in enforcing collection.

The third method is objectionable because of its unfairness in allocating large valuations to districts through which cars may operate very little, or possibly not at all, while many other taxing districts through which the cars operate receive no benefits from such operation.

The experience of Oklahoma and many other states has clearly demonstrated that freight cars of private car lines cannot be reached through ad-valorem taxation by local assessment. This is due to the difficulty, if not impossibility, of determining situs and establishing the average number of cars which were habitually used, or were physically present, in each taxing district. (See *Johnson Oil Refining Co.* v. *Oklahoma*, 290 U. S. 158; *American Refrigerator Transit Co.* v. *Hall*, 174 U. S. 70; *Union Tank Car Company* v. *McKnight*, 84 Fed. (2d) 421.)

Oklahoma has therefore selected the gross earnings method of taxing freight lines as the most practical under our constitution. Fortunately, our constitution is very liberal as to the various methods by which property can be taxed, and our supreme court has repeatedly held that it is not necessary that property be taxed ad valorem, but that the legislature may provide for the taxation of different classes of property by different means or methods.

There are, however, several suits pending in the federal courts in which the constitutionality of our freight car tax law is attacked. We believe that the decision of the United States Supreme Court in *Cudahy Packing Company* v. *Minnesota, supra*, clearly establishes the fact that our law does not violate any provision of the federal constitution, especially since we are required to lower the rate in any case where the tax is found to be more than it would be on an ad-valorem basis. The principal contention is that the effect of the equalization provision is to tax the cars ad valorem and that the law is therefore violative of our constitutional inhibition against levying an ad valorem tax for state purposes. We think it clear, however,

that the gross earnings tax, with or without the equalization provision, is not an ad valorem tax, and that our law is both constitutional and practical.

The equalization provision of our law, to which I have referred, reads as follows:

> "The Oklahoma Tax Commission, upon its own initiative, may, and upon the complaint of any person who claims he is taxed too great a rate hereunder, shall take testimony to determine whether the taxes herein imposed are greater or less than the general ad valorem tax for all purposes would be on such freight cars if taxed on an ad-valorem basis. The said commission shall have the power and it shall be its duty to raise or lower the rate herein imposed to conform thereto.
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> "It is hereby declared to be the intention of the legislature that the tax herein imposed be, as nearly as practicable, the equal of the amount of tax such freight line companies, equipment companies and mercantile companies would pay if their cars were taxed on an ad-valorem basis, including any value inuring to such cars by reason of being a part of a going concern.
>
> "In order to determine the amount of tax such companies would pay on an ad-valorem basis, said commission may value all cars of any company as a unit and allocate to Oklahoma that proportion of the total value which the Oklahoma car mileage bears to the total car mileage of the cars of any such company during the twelve (12) months period ending on June 30th, of any year, and may then apply to such value so ascertained the average ad valorem tax rate applied to property throughout the state for that fiscal year."

It is our opinion that the many states which fail to give any consideration to intangible, going concern and earnings value, in taxing freight lines, and fail to make a unit valuation with a state allocation based on car mileage, gross revenues, or both, are making a serious mistake, which not only deprives such states of taxes rightfully due them, but makes it more difficult for other states to properly administer and enforce their laws.

If any administrator is in doubt as to the validity of this method of valuation, we suggest he read the following cases:

Pullman Palace Car Co. v. Pennsylvania, 141 U. S. 18.
Adams Express Co. v. Ohio State Auditor, 165 U. S. 194.
Adams Express Co. v. Ohio State Auditor, 166 U. S. 185.
Western Union Tele. Co. v. Missouri, 190 U. S. 412.
Wisconsin & Michigan Ry. Co. v. Powers, 191 U. S. 379.
Cudahy Packing Company v. Minnesota, 246 U. S. 450.
Union Tank Car Company v. Wright, 249 U. S. 543.
Pullman Co. v. Murray, *et al.*, 171 Okl. 450.

AD VALOREM TAXATION OF CAR LINES ON THE BASIS OF EARNINGS

L. I. TEFFT

Tax Commissioner, Pere Marquette Railway

The rule of property taxation is that the value of the property is the basis of taxation. Given a definite method of arriving at the value of property, which in all cases would be fair and equitable, the question of producing the proper assessed valuation of any property would be quite simple. The difficulty, of course, is in determining the value of any specific property. The following factors are those most generally used as basic information in arriving at a conclusion:

a. Investment in property
b. Reproduction cost
c. Gross earnings
d. Stocks and bonds
e. Net earnings.

Our subject is that of taxation of car lines. The majority of private car line cars in freight service are tank and refrigerator cars; in passenger service, sleeping and parlor cars. In the different states the method of assessing this equipment varies. In a few of the states the assessment is made by local assessors. In most states, however, the assessment is made by the state tax commission, and when the ad-valorem basis is used, the value of the prpoerty, as a whole, is usually determined from reports furnished by the owning company, and the state assessment is generally apportioned on a mileage basis.

In my opinion neither investment in property nor reproduction costs represents the value of property, since value is dependent upon the use to which the property is or may be put and varies with the profitableness of that use. The stock and bond value of a property has a direct reflection upon its worth, but the ability of a property to earn, most directly reflects its value and its ability to pay taxes.

In this connection the following may be quoted from a decision of the United States Supreme Court in *C. C. C. & St. L. Ry. Co.,* v. *Backus,* 154 U. S. 439-445:

> "The rule of property taxation is that the value of the property is the basis of taxation. It does not mean a tax upon the earnings which the property makes, nor for the privilege of using the property, but rests solely upon the value. But the value of property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use. The amount and

> profitable character of such use determines the value, and if property is taxed at its actual value it is taxed upon something which is created by the uses to which it is put."

Probably the fairest way of producing system value is a combination of the so-called stock and bond method and the capitalization of earnings. In arriving at the value, the earnings of the company and the quotations of its securities should be taken over a period of representative years, with due consideration to existing business conditions. Quotations of the securities are dependent, to a considerable extent, on the income which the business has produced in the past and can be expected to produce in the future. Thus the stock and bond method is closely allied to the earnings method of valuation. Bookkeeping and maintenance procedure varies considerably between companies, and individual standards should be thoroughly investigated. For example, if the maintenance standard of one company is below that of others, a part of the gross earnings of that company finds its way into the profit and loss account and thus overstates the actual net revenue, and if the valuation should be produced by capitalizing the net revenue without consideration of such facts, the result would be inequitable. While this is mentioned in connection with the earnings, the same facts apply with equal force to the stock and bond method, since this latter to a large extent is dependent upon earnings. Should a company have no net earnings nor its securities be quoted on the market, the value may be produced by careful consideration of all available factors including gross revenues, operating expenses, sale value and salvage value.

In allocating values to states, after determining the system value, one of the mileage methods is usually resorted to. The supreme court of the United States, in the case of *Union Tank Line Company* v. *Wright*, 249 U. S. 275-282, said:

> "In the present case the comptroller general made no effort to assess according to real value or otherwise than upon the ratio which miles of railroad in Georgia over which the cars moved bore to total mileage so traversed in all states. Real values—the essential aim—of property within a state cannot be ascertained with even approximate accuracy by such process; the rule adopted has no necessary relation thereto. During a year, two or three cars might pass over every mile of railroad in one state while hundreds constantly employed in another moved over lines of less total length."

The court might have added that the earnings of the cars over the fewer miles in one state may have equaled or even exceeeded the earnings of the cars in another state over lines of a greater total length. Therefore, it appears to me that again we should refer to earnings, and in this connection it would seem fair to allocate value

to a state on the basis of the proportion that the net earnings within a state bears to the total net earnings in all states. In the absence of net earnings, gross earnings may be substituted, but when using gross earnings for allocating values to states, due consideration should be given to operating revenues and operating costs in the different states.

In the last analysis, no product or enterprise is worth one cent more than its economic or "utility" value to the public. When the public no longer has need for the service or product it matters little how much it would cost to reproduce the thing; it matters less how much was invested in it. The final test is: what is it worth to society? Formulas are merely rules of thumb set up in an effort to determine this worth. No rule of thumb will fit every case. Sound discretion is the only proper formula.

LOADING OF CAR LINE OPERATIONS WITH STATE INCOME TAXATION IN ADDITION TO STATE TAX ON EARNINGS

LOUIS B. DORR

To accommodate myself to the time limit imposed, close restriction to a small part of the field possible for discussion is necessary. Let me at the outset, therefore, specify that I speak from the viewpoint of the shipper-owner only, and with respect to those states in which *as shipper* such an owner does no business whatever of an intra-state character. But, with respect to operating car line companies who do no other business, my remarks, I think, can be extended as wholly applicable.

For years now the mileage tax has been accepted in lieu of an ad valorem tax on property, the theory recognizing constructive situs within the taxing state. These taxes have not been too burdensome in amount and on the whole are reasonably administered. But more recently has come the assertion of a state's right to impose its general income tax upon a company which is otherwise doing no business within the state, but is presumed nevertheless to have taxable income earned therein by reason of the rail movement of its cars in railroad possession.

For six long years at least, my business, your business, any business, has faced increasing tax burdens and tax problems of cumulating complexity. With budgets unbalanced, the congress and state legislators have sought every possible source of revenue which can be made the subject of taxation. They even have taxed their own ingenuity and that of their advisors—and almost it would seem to the point of diminishing returns.

By steadily broadening definitions of interstate commerce as interpreted by the supreme court and the interpretations of its interpreta-

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tions, old conceptions of demarcation between federal and state rights control and tax, either have been swept utterly away or tempered into such flexibility that no man knoweth or can plan for the next tax assault nor whence it may come. And so it has come about that the states themselves are reaching out beyond the barriers once imposed, seeking ways and means to impose tax burdens on commerce under the guise of local or intra-state relationship. Witness the "Use Tax" as a device to protect sales-taxed local business against the competition of out-of-state goods shipped in interstate commerce.

The founders of our government conceived a group of states free and equal in commerce among and between themselves and without tariff barriers. If the principle sought to be established by this "Use Tax" is to stand, it won't be long before every state boundary will bristle with customs guards. If mere ownership of cars in railroad service can subject non-resident and wholly foreign concerns to income taxation, then state after state will follow this new lead to revenue and for the car operator, particularly perhaps the shipper-owner, Ossa will be piled on Pelion to a weight that will crush the geese that have laid the golden eggs. A mixed metaphor, indeed, but no worse scrambled than the tax muddle for which we seem headed.

It is all good perhaps as a stimulant to government spending, but even better as a depressant on business initiative and activity.

Private ownership of railroad cars is of definite value in the national economy. Were railroads required, as must otherwise be the case, to provide all equipment necessary to their operations, we should read much more even than we do of railroad financial troubles. But in these very car line operations so useful to the railroads we have an instance of initiative and ability which of recent years has offered less and less incentive. For the shipper-owner, indeed, who contributes substantially to the provision of adequate railroad equipment, there now is little incentive except the realization of a convenience. His car line operation, involved in this steady drive for more and more tax revenues, is threatened indeed with loss.

How, then, shall this threatened income tax load be regarded? I believe that in the instance of most companies, and with respect to any state within which no usual business is done, such a demand for income tax should be disregarded.

I am supposing therefore a non-resident company not domiciled in or doing any business within the taxing state. As to such a concern I contend that requirement of an income tax return, either general with respect to its entire business though subject to the usual state allocation, or specifically with respect to its car line earnings, not only is unconstitutional but inequitable. Could it be upheld, only confusion unlimited could result. If one state can so tax, all can. It constitutes, unjustifiably, an attempt on the part of

the state to bring within its jurisdiction for tax purposes, concerns wholly foreign who do no business of any sort, interstate or otherwise, within that state. In the eyes of the proponents of such a measure mere ownership of a railroad car transported across the state by a railroad company, implies an earning by the owner within the state and jurisdiction of the state over the owner for the purpose of taxation. And that much achieved, how much further might they go?

Disregarding the moot question of whether such earnings are or are not interstate and exempt from state taxation, let us examine the *real question of whether we have any earnings at all made within the state.*

The car in use in its travels into, through, or out of the state is not within the control of its owner as owner. It is in the possession and complete control of the railroad company which uses it in its own business and pays a rental for such use. The contract of rental was made usually outside the state, and usually by parties domiciled in different states. The railroad uses it in substitution for its own equipment for the transportation of commodities. Even the rentals paid by the railroad for such use, and the terms of the rental contract are not finally fixed either by the owner or by the railroad but are determined by tariffs controlled by the Interstate Commerce Commission. Accounting is done between the parties and payments are made outside the state.

It has been contended that the fact that the goods transported, belonging to the shipper (in the case of shipper-owner cars), introduces an element of shipper interest which makes the rental incident to the movement and profit in the sale of such goods. Why should it?

Provision of its equipment by the railroad is one function of railroad operation. It may purchase or rent as it finds economical or convenient. Transportation of goods for hire is its service function and the tariff charged for transportation is not based upon how the equipment is obtained, is not different or subject to any change by classification or otherwise if it happens, as of course it often does, that the goods in transit belong to the owner-lessor of the equipment in which they move.

Let this attempted extension of right to tax beyond the confines of state boundaries succeed and no business will or can know the full extent of its tax liability.

FOURTH SESSION

MONDAY, OCTOBER 24, 1938, 8:00 P. M.

CHAIRMAN LELAND: The first thing I want to call to your attention tonight is the fact that our rules provide for a resolutions committee. It has been customary for the president to designate the chairman, and the states then separately select their own representatives on the resolutions committee. It is necessary for them to ballot until they can get one person duly chosen.

So far as I can see, the most logical candidate for chairman of the resolutions committee is Mr. Henry Long, and I duly appoint him chairman of the resolutions committee. I have learned by experience that we had better have him as chairman and avoid all the changes from the floor that we have customarily had. It seems to me that if experience teaches us one thing, it is that Henry is a great resolver, and that he is the most qualified from all points of experience to serve as chairman of that committee.

Now I want to call your attention to this fact: the other members of the committee are selected by states, and to the extent that we have 48 states, it means a potential committee of 49 members. Ordinarily, they select a subcommittee to pass on the resolutions, delete those they don't like, and the result is that the meetings are largely attended by those who are interested in pushing forward particular resolutions at particular times.

It has seemed to me, and to some of the members who have served on the committee before, that that arrangement is rather unwieldy, but out of reverence for constitutional forms, and the procedures which govern all well-regulated bodies, it is necessary for us to announce an intention to amend the constitution; it is necessary then for us to get a vote on it, and to hold the thing over at least for twelve months so that we shall not make the mistakes which our forefathers made by allowing constitutions to be more quickly amended.

It seems to me that among the things we ought to think about during the interim before the business meeting is the desirability for simplifying our procedures with reference to the resolutions committee, so that we can get a committee that is manageable in size, that can be held responsible for its acts, and at the same time will not be appointed or designated by the presiding officer, so as to lose all semblance of democratic appearances. I would like for

you to think about that so that we may get a better type, a more flexible type, of arrangement.

I mention that for the reason that I don't know what resolutions are coming up, and so that the point will be made without reference to any particular controversy. I hope that none arises at this session, but should it arise, I want all of you to be on notice that at least some of us think—that is the machine; the machine thinks—that we ought to have some simplified procedure. But I believe it ought to be a democratic process, and that there ought to be some provision set up for selecting a smaller group.

The second job that falls on the chairman is to select a committee on credentials. The main job of the committee on credentials is not to do anything unless we get in a scrap, and then their work consists of disqualifying all ineligible voters. That is rather easy, since we vote by states, and the states can in part decide on that, unless they get into a controversy. So that the amount and volume of work of the credentials committee isn't very great.

I want to appoint that committee, and I will designate Mr. Draper Allen, of Michigan, as chairman, Mr. Royal Cushing, of Illinois, and Mr. Dixwell Pierce, of California, as the other member of that committee.

That is all the real business that I have at this juncture. I want to say that those of you who are in charge of state delegations want to get your groups together in an appropriate caucus and select your resolutions committee members before tomorrow evening, because if it isn't done by tomorrow evening, then the rules also provide that that is one of the prerogatives which the president may exercise in designating the members of that committee from those states not yet appointed, and it may well be that if you don't appoint your delegates I will control the thing the way I want to.

This evening's program bids fair, I think, to be one of the most interesting that we have in a very interesting day. The general subject for discussion is that of tax exemptions.

It is my pleasure to introduce tonight as the presiding officer for this meeting Dr. Charles W. Gerstenberg. That gives me more pleasure than anything I have done thus far, I think, in this conference. There have been few people who have been as helpful to me while I have had any work to do with the association as Mr. Gerstenberg. He has been on two program committees, he has been a wheelhorse for work, he has been full of profitable, practical and helpful suggestions, and it is a pleasure to acknowledge a debt of gratitude publicly to him. He has been an old member, he has come many, many times, and he needs no introduction.

Mr. Gerstenberg, it is a pleasure to turn over this symbol of authority to you to use as you will.

(Mr. Gerstenberg was handed the gavel.)

CHARLES W. GERSTENBERG, presiding.

CHAIRMAN GERSTENBERG: Well, I presume that most of us are getting to the place where the memory of man runneth not to the contrary in our attendance at the National Tax Association conferences.

We are to talk tonight on the subject of tax exemptions. We who have practiced law and who have taught law know that it is a very living thing, and that it grows constantly. It grows so fast, indeed, that this year the subject of the recent decisions of the supreme court had to be divided into two parts. Part of it was presented this morning by Professor Traynor, as you will remember, and this evening we are to have that special part of it which deals with tax exemptions.

Professor Henry Rottschaefer, of the Law School of the University of Minnesota, is to give us the first paper on "The Limits on the Doctrine of Implied Immunity in the Light of Recent Decisions." That is, the immunity from federal taxation of the states and state instrumentalities, and vice versa. You will now listen to Professor Rottschaefer.

HENRY ROTTSCHAEFER (Minnesota): Mr. Chairman, I come from a state where at least some of its institutions are noted for their timing—the football team, for instance. I come to a group and am glad to hear that it is a group that reveres its constitution so thoroughly that it requires an announcement in advance when it is to be amended. The subject of my talk is really about a constitution that is frequently amended without advance notice, to either counsel or client.

THE LIMITS ON THE DOCTRINE OF IMPLIED IMMUNITY IN THE LIGHT OF RECENT DECISIONS

HENRY ROTTSCHAEFER

Professor of Law, University of Minnesota

The supreme court of the United States rendered several decisions during the past year in which it re-defined the scope of the implied immunity of the state and its agencies from federal taxation. In one of them, *Helvering* v. *Mountain Producers Corporation*,[1] it expressly overruled two earlier decisions, *Gilespie* v. *Oklahoma*[2] and *Burnet* v. *Coronado Oil & Gas Co.*;[3] while in another, *Helvering* v. *Gerhardt*,[4] it in effect overruled *Brush* v. *C. of I. R.*,[5]

[1] 58 S. Ct. 623.

[2] 257 U. S. 501, 42 S. Ct. 171, 66 L. Ed. 338.

[3] 285 U. S. 393, 52 S. Ct. 443, 76 L. Ed. 815.

[4] 58 S. Ct. 969.

[5] 300 U. S. 352, 57 S. Ct. 495, 81 L. Ed. 691.

in so far as the latter decision rested upon the constitutional theory of the reciprocal immunity of the state and nation from taxation by the other. All of us are familiar with the suggestions that have from time to time been made by official and unofficial spokesmen of the present administration urging the levy of federal income taxes upon future compensation of state and municipal officers and employees and upon the interest on future issues of state and municipal bonds. The aim of the present discussion is to consider the extent to which recent decisions throw light upon the probable validity of incorporating such changes into our federal tax system and of comparable changes in the tax systems of the states providing for the taxation of federal salaries and future issues of federal bonds and the interest thereon.

The significance of the recent decisions can be determined only against the background of prior decisions applying the immunity principle. This principle is itself merely a specific instance of the broader principle that neither the federal government nor a state may so exercise their respective powers as to unduly burden or impair the effective exercise by the other of the powers belonging to it under the distribution of governmental powers effected by the federal constitution. The "implied immunity doctrine" is, accordingly, a device for the maintenance of the federal system established by that constitution. The course of the decisions in which its scope has been defined represents, in the final analysis, a compromise between the desire to protect each government from the effects of exercises of the other's taxing power and that of not so severely restricting that power as to unduly impair the sources of taxation. The principal devices through which this has been accomplished have been (1) the principle that immunity exists against such taxes only as produce an immediate and direct burden upon the function of the other government claimed to be affected by their imposition; and (2) the principle that, at least so far as the immunity of a state is concerned, it exists only if the immediate and direct burden is upon an essential governmental, as distinguished from a non-essential governmental, function. It is certain that, if the scope of the implied immunity is narrowed, it will be done through imposing more rigorous tests of the immediacy and directness of the effects of a tax, and by limiting the scope of the concept of essential governmental functions. It is wholly improbable that the court will adopt the view that the immunity is against discriminatory taxation only.

The question, therefore, is whether the recent decisions reveal any tendency on the part of the court in either of these directions. There has been developed no very precise test of when the burden of a tax is so immediate and direct as to be invalid under the principle now being considered. It is clear that the existence and extent of the burden cast upon the functions of the one government by a tax levied by the other is a question of fact inextricably bound

up with the problem of the shifting and incidence of taxes and of their direct and indirect economic effects. Its existence and extent is thus a question of fact, not of law. Those facts acquire legal significance only to the extent that they have been recognized as factors in answering the legal problem of whether whatever burden in fact results is to be described as immediate and direct within the meaning of the "implied immunity" doctrine. The earlier decisions affirming or denying the existence of this immunity with respect to particular taxes did not condition the existence thereof upon proof that the tax in fact imposed any burden upon the activities of the other government. This does not mean that the factual existence of some burden was irrelevant, but only that it seems to have been assumed. The emphasis, therefore, was upon other tests. The issue of whether a given tax imposed by the one government immediately and directly burdened a governmental function of the other was determined by considering the subject upon which the tax was imposed and the relationship between the latter government and the instrumentality subjected to the tax. The former of these was stressed in holding invalid state taxation of federal property and federal activities, while the latter was a principal factor in defining the extent to which a tax imposed upon a private agency or instrumentality was prohibited under the principle of reciprocal immunity. Thus the salary of a state official was held immune from a federal income tax [6] while the income received by an independent contractor with a state was held taxable by the federal government.[7] It was especially in the cases in which private agencies were availed of by government to aid in carrying out its policies that the decisions revealed a marked degree of uncertainty and inconsistency, and it is my opinion that the immunity principle was frequently carried to extreme lengths. This trend received a definite, and undoubtedly a permanent, check in the recent decision in *Helvering* v. *Mountain Producers Corporation* which has already been mentioned. This was merely the culmination of a trend toward a narrower construction of the immunity that was definitely initiated by the decision in *Willcutts* v. *Bunn.*[8]

The decisions of the supreme court during the last seven years disclose several important factors as directly responsible for this trend. The first of these is a growing judicial recognition of the fact that every expansion of the immunity principle reduces the tax sources of the government whose tax is held invalid thereunder. This factor was referred to in *Willcutts* v. *Bunn* and in many subsequent cases. It was coupled in *Helvering* v. *Mountain Producers Corporation* with a stressing of the expanding revenue needs of

[6] *Collector* v. *Day*, 11 Wall. 113, 20 L. Ed. 122.

[7] *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, 46 S. Ct. 172, 70 L. Ed. 384.

[8] 282 U. S. 216, 51 S. Ct. 125, 75 L. Ed. 304.

both state and nation. The result of this increasing emphasis on this factor has been to make the court more critical of claims that a given tax immediately and directly burdens a governmental function, and to lead it to require such claims to be more clearly and definitely proved. A second factor operating in the same direction has been the judicial view that the principal beneficiaries of the immunity have been private persons whom the court in *Helvering* v. *Gerhardt* referred to as a "privileged class of taxpayers." It is quite clear from the decisions and opinions in the two cases just referred to and in *James* v. *Dravo Contracting Co.*[9] that the court's emphasis on these factors has been in large measure responsible for its theory that the burden of a tax upon a governmental function is not necessarily immediate and direct merely because it increases somewhat the cost of performing that function, and that, to the extent that such increase is a factor therein, its existence will have to be definitely established rather than left to conjecture. It is clear that these judicial views contain no positive test for determining whether a burden is immediate and direct. The importance of the recent decisions in this connection is, therefore, to be found in the shifting of emphasis and the changed judicial point of view which they indicate.

It is an extremely difficult and hazardous task to deduce particular conclusions from so vague a set of premises. The question, therefore, arises whether there is anything in the recent decisions and their accompanying opinions indicating how far the court is likely to reduce the present scope of the reciprocal immunity theory by permitting taxation in situations in which it has heretofore been held invalid. It should be noted that, so far as the test now being considered is concerned, the taxes sustained by the recent decisions were all upon private persons who would have been the direct beneficiaries of the immunity had it been allowed. There is, therefore, nothing in them to warrant a view that either government will be allowed directly to tax the other's performance of its strictly governmental functions. A tax on sales to either of articles required for the performance of such functions is probably still invalid under the immunity principle. A tax on governmental bonds, or on the income therefrom, is clearly one on the private owner of such bonds. The recent decisions, therefore, raise the question whether their principles imply a change of law with respect to the taxation of such bonds and the interest thereon. In *James* v. *Dravo Contracting Co.* the court expressly distinguished a tax on governmental bonds from one on the contracts by which governments bargain for the services of independent contractors, and described the immunity of the former as based on the recognition that a tax on the bonds would directly burden the power to borrow. It is unlikely that the

[9] 58 S. Ct. 208.

recent decisions indicate that the court would sustain state taxation of either the capital value of federal bonds or of their income. They contain no specific support for a view that a federal tax on the interest from state and municipal bonds would merely indirectly and remotely burden the state's power to borrow for governmental purposes, and be valid on that theory. A tax on the salary of a state or federal officer or employee engaged in the performance of the governmental functions of his government is also clearly a tax on a private person. The recent decisions thus also raise the question whether the immunity of the salaries of such officers and employees from taxation by the other government still exists. There is nothing expressly in these decisions requiring an inference that such officers and employees are, with respect to this matter, in the same position as independent contractors with the state or federal government. The reasoning of *Helvering* v. *Gerhardt* leaves it uncertain whether the basis for the decision is the fact that the state employee involved therein was engaged in a non-essential governmental activity or that a tax on his salary would not directly burden the function involved. If the latter be the real basis, then the decision would warrant an inference that a non-discriminatory tax on the salary of a state governmental employee would not directly burden the function in connection with which he was employed. The more probable basis for the decision was the non-essential governmental character of the activities of the port authority, and, accordingly, the decision cannot be construed as impliedly rejecting for the future the theory of earlier decisions that a tax on the salary of a public officer or employee engaged in connection with an essential governmental function constitutes an immediate and direct burden upon such function and is for that reason invalid.

The distinction between so-called essential governmental and non-essential governmental functions as related to the scope of the reciprocal immunity herein being considered has always been a difficult one to draw. However, the trend of the recent decisions is clearly toward limiting narrowly the scope of those state activities which are immune from federal taxation. This is the clear implication of *Helvering* v. *Gerhardt,* sustaining a federal tax on the salary of an engineer of the port authority, and of *Allen* v. *Regents of University System of Georgia,* sustaining a federal admissions tax upon admissions to intercollegiate athletic contests conducted by state universities. The most important factor in defining a non-essential governmental function is that the activity is of a kind comparable in all essentials to those usually conducted by private enterprise. The trend towards reducing the scope of the immunity by increasing the scope of non-essential governmental functions that are not entitled to immunity has been hastened by the expansion of state activities to include many business enterprises. Several of the recent decisions have, moreover, contained intimations which would

greatly limit the scope of the implied immunity if made the basis for the subsequent development of the law in this field. In *Helvering* v. *Therrell,*[10] sustaining a federal income tax upon the salary of a liquidator of state banks who had been appointed by a state department, the court defined essential governmental functions as "those duties which the framers (of the constitution) intended each member of the Union would assume in order adequately to function under the form of government guaranteed by the constitution." In the course of its opinion in *Helvering* v. *Gerhardt*, they were described as "those governmental functions which they (the states) were exercising when the constitution was adopted and which were essential to their continued existence." If these tests are ever adopted, the number of essential governmental functions that may not be directly burdened by a tax imposed by the other government will be reduced by eliminating some that have heretofore been deemed to be within that class. This will involve the liability to federal taxation of the compensation of state officers and employees engaged in connection with state activities other than those in which states were engaged when the constitution was adopted, or than those essential to their continued existence as governmental units in our federal system. A probable shrinkage of even greater magnitude would occur in what constitute essential governmental functions of municipalities, with a concomitant increase in the scope of federal taxing power. It would also be perfectly logical to subject bonds issued to finance the capital requirements of non-essential state governmental functions to federal taxation, and it would not be inconceivable that federal income taxes should be levied upon the net income of state and municipal activities that are non-essential governmental functions because of their resemblances to private business undertakings. A federal excise tax on some of such activities was sustained in *U. S.* v. *South Carolina,*[11] *Ohio* v. *Helvering,*[12] and *North Dakota* v. *Olson.*[13] It is a practical certainty that the court would, if it adopted this theory, today sustain a federal income tax upon the salaries of many state and local officers and employees heretofore deemed immune therefrom. It is impossible to say whether the court will in the near future adopt the narrow view of essential state governmental functions at which its dicta have intimated. If it does, the federal government will have been equipped with a powerful instrument for affecting state and local governmental activities. The states will have no offsetting advantage in relation to the federal government for two reasons. In the first place the supreme court has never yet sustained a state tax

[10] 58 S. Ct. 539.

[11] 199 U. S. 437, 26 S. Ct. 110, 50 L. Ed. 261.

[12] 292 U. S. 360, 54 S. Ct. 725, 78 L. Ed. 1307.

[13] 33 F. (2d) 848.

affecting a federal activity on the score that the activity was not an essential governmental function of the federal government. In the second place congress has the power to confer upon such activities, even when conducted through private agencies, an immunity from state taxation whenever to do so can be held reasonably necessary and proper to achieve an objective within the competence of the federal government.

The supreme court sustained the imposition of a federal income tax upon the salary of a state bank liquidator in *Helvering* v. *Therrell* in part because his compensation was paid from the assets of the banks and not from state funds. It is possible to deduce from this a principle that would permit the federal government to tax the compensation of state officers and employees paid from funds received by way of grants in aid made to the states or local units from the federal treasury. No court decision has yet taken that position, but federal taxing authorities have assessed federal income taxes upon state university employees so far as charged against funds paid such university by the federal government. *Helvering* v. *Therrell* furnishes some support to their position.

In a concurring opinion in *Helvering* v. *Gerhardt* Mr. Justice Black stated that the entire subject of intergovernmental tax immunity should be reopened and reviewed in the light of the provisions of the sixteenth amendment. That amendment provides that "congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." It is undoubtedly the opinion of Mr. Justice Black, and of some others in high places, that the phrase "from whatever source derived" means that the amendment has eliminated the restrictions placed on the federal taxing power by the principles of intergovernmental tax immunity. It is not impossible to read that into the amendment by a process of construction that ignores the historical background and purpose of the amendment. If those be considered, then it is quite certain that the phrase was inserted because the Pollock cases [14] had made the source of the income the decisive factor for determining whether a federal income tax was a direct or indirect tax, and that the purpose of the amendment was to relieve federal income taxation of income from property sources from the necessity of apportionment among the states on a population basis to which it had been held subject by the holding in the Pollock cases that a tax on income from property was a direct tax. This is the construction of its purpose and effect thus far adopted by the decisions of the supreme court. It has in more than one opinion stated that the sixteenth amendment had not rendered taxable anything not taxable by the federal government prior to its adoption.

[14] 157 U. S. 429, 15 S. Ct. 673, 39 L. Ed. 759.

That construction is one that is more consonant with generally accepted canons of interpretation than is the construction implicitly suggested by Mr. Justice Black. The court is not likely to change its position as long as it remains an independent body. A change would, in any event, affect only federal taxation of income, and not other aspects of the problem of intergovernmental tax immunity which were considered in the first part of this discussion.

It may be stated in conclusion that any modifications that are likely to be made in the scope of principles of intergovernmental tax immunity through judicial decisions are almost certain to be more beneficial to the federal government than to the states, and that, furthermore, no judicial decision is going to change the fact that congress can confer immunity upon federal agencies even where none exists under the principles of implied immunity. It would seem desirable to deal with the whole matter by constitutional amendment if the principle is to be eliminated or seriously modified.

CHAIRMAN GERSTENBERG: We have been very fortunate each year in having at least one member of the federal body of administrators join in our discussion. Last year you will remember Mr. Roswell Magill favored us; and this year we have with us the chief counsel of the Bureau of Internal Revenue at Washington, Mr. John P. Wenchel, who will speak to the subject, "The Federal Point of View," the general subject being, "The Federal Taxation of State and Local Bonds."

We are very happy indeed to have a representative of the federal government here, and we welcome Mr. Wenchel.

THE FEDERAL TAXATION OF STATE AND LOCAL BONDS

THE FEDERAL POINT OF VIEW

JOHN PHILIP WENCHEL
Chief Counsel,
Bureau of Internal Revenue

I have been invited to examine with you the proposal to take legislative action to eliminate any existing immunity from income taxation of the interest on future issues of governmental obligations and compensation paid governmental officers and employees. Activity to abolish these immunities is by no means of recent origin, although the discussion of the subject has been revitalized by the president's message to the congress of April 25, 1938 in this connection.

It was recognized soon after the inception of income taxation that reciprocal governmental exemptions from taxation are costly to government, federal, state and local. Thus, from time to time, proposals looking toward the entire or partial elimination of the exemption provided for in federal revenue laws have been submitted to the congress. At various times, steps have also been taken to eliminate any implied constitutional immunity by means of a constitutional amendment. While the object sought to be attained through the ratification of an amendment would probably have been accomplished thereby, nevertheless, in the absence of an amendment, the effort should be made to attain the same end by the use, if permissible, of a less cumbersome method of achieving the result, if the result is worth achieving. I believe it can be demonstrated that the object is a worthy one. Moreover, the time is propitious to seek to accomplish this result by legislation. I base this statement on the fact that there may be found in the instant situation all those elements which in other cases impelled the court to revise and restate prior well-established doctrines. As Walter Lippman, writing in his column in the *New York Herald-Tribune* on this subject, says:

> "President Roosevelt has now proposed to overcome this difficulty by enacting a federal statute ending the immunity for the future, and letting the supreme court say whether the old precedents stand or whether the constitution can be re-interpreted. The president's suggestion is not, as some commentators have suggested, another attack on the judiciary and on constitutional principle. In spite of the decisions there is a real doubt about the whole matter. The constitution is silent about it and it would be entirely proper for congress to ask the court to reconsider the problem."

Judicial history of the supreme court indicates that the court does not hesitate to reverse itself where conditions so warrant. The court seems to recognize that judicial doctrine needs re-examination from time to time, in accordance with the demands of changing political, sociological and economic trends. So, too, does the court frequently admit that it had previously fallen into error, when that is the case. The court views "stare decisis" as a useful rule and not an inexorable command.[1] Thus, we find that ten earlier decisions have been overruled by the court in the last eight years, at least six of which had announced important doctrines.

It may be interesting for us to extract from these later cases the elements therein which impelled restatement, and for us to compare them with the instant situation. A comparison reveals that there are present here all of the factors which, either singly or in com-

[1] Mr. Justice Reed in *Erie Railroad Co.* v. *Tompkins*, (1938) 304 U. S. 64; Mr. Justice Brandeis in *Jaybird Mining Co.* v. *Weir*, (1926) 271 U. S. 609, 619.

bination with others, led to restatement in the individual cases.[2] Thus it seems clear that the court might be willing to find grounds upon which to base a restatement of the doctrine of immunities. That there are such grounds is borne out by respected legal opinion, with which I concur. I attempted to analyze the case material and to indicate the possible grounds in an address which I made last May before the Federal Bar Association.[3] No useful purpose would be served by going over the same material again. The conclusion that the court would re-examine and restate would seem particularly to be correct when it is known that the case before it would involve fair, nondiscriminatory legislation such as the president has proposed.

Moreover, the difficulties inherent in the application of the doctrine supply cogent reasons for re-examination. No definite rules can be found in the court's decisions which can be readily used in the administration of tax laws. What "burdens" threaten destruction of the government so that immunity from taxation should be accorded in any particular case, and what practical rules there are which govern the difference between governmental and proprietary functions are still unanswered questions from an administrative viewpoint.

[2] The following factors may be found in those cases: (1) The "expanding needs of the state and the nation" (*Helvering* v. *Mountain Producers Corp.*, (1938) 303 U. S. 376; (2) the intervening "economic conditions" requiring re-examination of the "reasonableness of the exercise of the protective power of the state" (*West Coast Hotel Co. v. Parrish*, (1937) 300 U. S. 379; (3) the fact that prior decisions had come to be out of harmony with the trend of later decisions (*Fox Film* v. *Doyal*, (1932) 286 U. S. 123); (4) the doctrine tended to "disturb good relations among the states and produces the kind of discontent expected to subside after establishment of the Union" and that it "has been stoutly assailed on principle" (*Farmers Loan Co.* v. *Minnesota*, (1930) 280 U. S. 204); (5) research by competent authorities has shown that the court placed an erroneous construction on the original document used as a basis for the doctrine and that "experience in applying the doctrine" has "revealed its defects, political and social" (*Erie Railroad Co.* v. *Tompkins*, *supra*); (6) "the benefits expected to flow from the rule did not accrue" and the impossibility of discovering a satisfactory line of demarcation has created a new well of uncertainties" (*Erie Railroad Co. v. Tompkins, supra*); (7) the doctrine has "introduced grave discrimination," its "mischievous results have become apparent" (*Erie Railroad Co.* v. *Tompkins, supra*); and "the practical effect of it has been bad" (*Farmers Loan Co.* v. *Minnesota, supra*); (8) the doctrine has "rendered impossible equal protection of the law" and "in attempting to promote uniformity of law throughout the United States," it has prevented uniformity in the administration of the law" (*Erie Railroad Co.* v. *Tompkins, supra*); and (9) the "distinctions maintained with respect to the doctrine "have attenuated its teaching and raised grave doubt as to whether it should longer be supported" (*Helvering* v. *Mountain Producers Co., supra*).

[3] Wenchel, (1938) "Legal Aspects of Tax-Exempt Privileges," address before Federal Bar Association, printed in 83 Cong. Rec. No. 107, May 25, 1938.

The court has held that federal tax on "proprietary" functions of a state, though the state itself must pay the tax directly, is not a burden which threatens our dual system of government.[4] The converse of this proposition is that a tax on a governmental function is bad. A governmental function is not, however, a constant element. What may be a usual governmental function today may be taken over by private business tomorrow and thus fall into the "proprietary" class when a government engages in it. What may be a "proprietary" function today, such as the furnishing of electric power, may in the future become such a "usual", "ordinary", or "essential" governmental enterprise that it may be classed as a "governmental" function instead of a "proprietary" function. There will be, and have been, constant changes in the fields of enterprise which we as a people properly look to the various state governments and the federal government to administer. In addition to these difficulties, the governmental functions which warrant tax exemption are not definitely fixed. In one case they were said to be those which are "strictly" governmental; [5] in other cases, those which are "essential" governmental functions; [6] in another case those which are "traditional" governmental functions; [7] in another case those which were "usual" governmental functions, and in *Helvering* v. *Therell*,[8] the court said that "essential government duties" meant "those duties which the framers [of the constitution] intended each member of the Union would assume in order adequately to function under the form of government guaranteed by the constitution." In *Helvering* v. *Gerhardt*,[9] the court singled out "indispensable functions" of the state and "functions essential to the continued existence of the state government" as the ones which might be protected by the immunities doctrine, although there was no holding that even those were protected. Thus, confusion has run rife, making administration of the tax laws uncertain and difficult.

Has not, therefore, "the impossibility of discovering a satisfactory line of demarcation" in the immunities doctrine created such a deep "new well of uncertainties" as to make it advisable and necessary to re-examine the whole basis of the doctrine?

Even greater evidence that the court is willing and ready to re-examine the numerous implications of the doctrine of implied immunities upon proper presentation of the issues involved is contained in the decision rendered May 23, 1938 in *Helvering* v. *Gerhardt*,[10]

[4] *Ohio* v. *Helvering*, (1934) 292 U. S. 360; *South Carolina* v. *United States*, (1905) 199 U. S. 437.

[5] *South Carolina v. United States*, *supra*, at page 467.

[6] *Flint* v. *Stone Tracy Co.*, (1910) 220 U. S. 107, 172; *Brush* v. *Commissioner*, (1937) 300 U. S. 352, 362.

[7] *United States* v. *California*, (1936) 297 U. S. 175, 185.

[8] (1938) 303 U. S. 218.

[9] (1938) 304 U. S. 405, rehearing denied Oct. 10, 1938.

[10] *Supra*, note 9.

popularly referred to as the Port of New York Authority case. The case involved the validity of the federal income tax as applied to the salaries of the employees of the Port of New York Authority, a bi-state corporation created by a congressionally approved compact between New York and New Jersey. The corporation built and operated bridges, tunnels and freight terminals. The court held that the federal government had the constitutional power to tax the salaries of these employees.

While one may limit the decision to the particular facts of the case, the implications in it arising from the *obiter dictum* in the opinion are of great importance as being a definite indication that as cases arise the doctrine of immunities in all its phases will be re-examined in the light of modern thought and trends. The majority did not find it necessary explicitly to overrule any of its prior decisions, but quite definitely veered away from any restricted or narrow application of its previous dicta by indicating that when the proper issues are brought before the court definite, administratively workable new outlines of the immunities doctrines will be drawn. Mr. Justice Black in a separate concurring opinion urged a complete re-examination of the whole inter-governmental immunities question, in the light of the unequivocal language of the sixteenth amendment and the questionable validity of the doctrine itself.

In order not to trespass upon ground covered by others, I confine my remarks to the federal aspects of this problem. For the same reason, I do not propose to discourse at length on the legal material. I need only point out that a study of the history of the sixteenth amendment will demonstrate that there is no good reason why the language of the amendment should not be held to mean exactly what the dictionaries all say it means. So also, on principle, the doctrine of immunity from federal taxation of the compensation of state officers and employees and interest from state obligations was erroneously conceived and on re-examination should be abrogated. Through the case material we may trace the nature and growth of the "burden theory" as applied to tax exemption. It indicates that the rigid application of the immunities doctrine by the courts threatened serious impairment of the scope of the power to tax and that the effect of such application of the doctrine made necessary so many loosely defined qualifications that a re-examination of the whole field is of vital necessity. Without destroying the ability of the states to carry on their functions, the court has already sanctioned taxes which place burdens on the states equal to any possible burden resulting from the proposed legislation. Cases such as *Flint* v. *Stone Tracy Co.*,[11] *South Carolina* v. *United States*,[12] *James* v. *Dravo Contracting Co.*,[13] and many others amply illustrate this.

[11] *Supra*, note 6.

[12] *Supra*, note 5.

[13] (1937) 302 U. S. 104.

On the other hand, the available statistics and the opinions of fiscal and economic experts support the widespread conviction that tax exemption is costly to government and demonstrate that there is an economic and social necessity for this legislation. This may be illustrated by the example of a taxpayer who has an income of one-half million dollars and who owns a tax-exempt bond bearing interest at the rate of 3 percent per annum. You will find that this bond yields to him a rate equal to more than 10 percent on a taxable bond. To state the same proposition slightly differently, such a taxpayer who owns a bond subject to federal income tax, which bond bears interest at the rate of 10 percent per annum, will have a net yield, after deducting federal income tax, equivalent to less than 3 per centum of the amount of such bond. Notwithstanding this, you will also find that the difference in interest on a tax-exempt bond and a taxable bond is slight and does not reflect this tremendous discrepancy. Statistical analysis indicates that under present-day conditions tax exemption results in a large excess of revenue loss over possible interest saving. A table showing the value of the tax exemption privilege to individuals according to income classification is most interesting.[14] You may also be interested to know that careful analysis indicates that the elimination of this privilege would not result in more than a slight additional interest cost to the federal government, which cost would be tremendously overbalanced by the increase in tax revenue.

In addition to all this, the effect of the existence of tax-exempt bonds upon the business life of the country is decidedly bad. This conclusion seems to be shared by the report of the Twentieth Century Fund as paraphrased by the press, as well as by analysts generally. If, as is generally recognized, the life blood of capitalism is the free flow of new funds into new private enterprise, then any

[14] Gross Annual Yield required on a Taxable Security by a Married Man with No Children or other Dependent, to provide the same Net Yield after Federal Income Taxes as on a Wholly Tax-Exempt Security at Various Yields, for Selected Cases *

Net income from other sources	Yield on tax-exempt security, percent				
	1	2	3	4	5
$ 5,000	1.04	2.08	3.12	4.16	5.20
10,000	1.10	2.20	3.30	4.40	5.50
20,000	1.18	2.36	3.54	4.72	5.90
50,000	1.45	2.90	4.35	5.80	7.25
100,000	2.44	4.88	7.32	9.76	12.20
500,000	3.57	7.14	10.71	14.28	17.85
1,000,000	4.17	8.34	12.51	16.68	20.85

* Treasury Department, Division of Research and Statistics, May 26, 1938.

system which impinges upon that flow definitely retards economic advance. Those who can best supply new funds for private enterprise are those of wealth, since they are best able to take the risk incident to new enterprises. If those who would normally supply the funds for new enterprises find greater inducement in tax-exempt securities, it necessarily follows that the diversion of such funds would result in the absence of employment of those who would normally be employed in such new enterprise. It seems clear that unemployment increases the burden of government, necessitating the issuing of additional tax-exempt securities under the present system and the increasing of rates of tax, thereby according greater inducements for those of means to invest in tax-exempt securities. Thus the spiral has continued to date and will continue, the tax exemption increasing the burden of government, and the increased burden enhancing the value of the exemption. But even if the existence of tax exemption did not increase the burden of government, and even if it were not a retarding factor in the economic life of the country, it should be abolished as a matter of principle. No democracy should countenance, let alone aid and abet, any system which permits to exist a class which does not share proportionately in the burdens of government, and particularly is that true where the class exempted is shown to be most able to pay. At the present time our income taxes are based, in this respect, not upon ability to pay nor upon the amount of income received, but upon the source of that income. It is now recognized as fundamental equity that the burdens of government should be borne according to ability to pay and that ability is determined by the amount of income available with which to pay taxes and is in nowise dependent upon the source of that income. Therefore, our theory of taxation requires that all income be taxed, in the language of the sixteenth amendment, "from whatever source derived," and as is pointed out by Mr. Justice Roberts in *Brush* v. *Commissioner*,[15] that principle is applicable not only to the tax-exempt bond but to the governmental employee who shares in the benefits accorded all citizens and who should pay his share of the cost of providing those benefits, whether the tax therefor is realized by property tax, sales tax, or net income tax.

CHAIRMAN GERSTENBERG: I am glad to tell you that copies of that talk have been mimeographed and will be distributed at the close of this meeting. They will not be distributed, however, before the close of the meeting, so you will lose nothing by staying with us. Please stay with us.

I don't know if you realize all the dynamite that may burst forth from what we are hearing here tonight. I am sure the discussion following the formal papers is going to be very interesting indeed.

[15] *Supra*, note 6.

We are very fortunate in having with us this evening Frederick L. Bird. Mr. Bird is the director of municipal research of the Dun & Bradstreet organization. Those of you who have been following their magazine will realize its very interesting and informative articles on taxation in recent issues.

I have great pleasure in introducing to you now Mr. Bird, of the Dun & Bradstreet organization.

THE FEDERAL TAXATION OF STATE AND LOCAL BONDS EFFECT ON STATE AND LOCAL GOVERNMENTS

FREDERICK L. BIRD

Dun & Bradstreet, Inc., New York

It should be possible to consider the effect on state and local governments of the federal taxation of state and local bonds without arraying ourselves in two armed camps. This issue, instead of looming up like a controversy among nations, should be susceptible of amicable resolution, in the interest of a sound federal-state-local tax system, by units of government which draw from the same aggregate of tax resources.

There is no question that the presence of tax-exempt securities seriously impairs the effectiveness of progressive income tax systems for the federal and state governments and that the ability of possessors of large incomes to avoid payment of taxes through investment in tax-exempt securities is a source of discontent among the general mass of taxpayers. There is no question of the need for an equitable tax system and no question of the need of the federal government for more tax revenue.

The exponents of the interests of state and local governments, therefore, could well view with equanimity the proposal for federal taxation of state and local bonds if they were assured that the fiscal problems of the state and local governments were receiving the earnest and intelligent consideration of the federal authorities. There has been considerable evidence in recent years, however, not only of a federal awareness of some of these problems but of attempts to drive shrewd bargains and to promote fiscal policies detrimental to the interests particularly of local governments.

It stands to reason that any transition from tax-exempt to taxable state and local bonds should be equitable and clear-cut, and with a due regard for its probable effect on the finances of the various levels and types of governmental units and functions. These justifiable considerations will not be met if the process of transition is clothed in an atmosphere of discrimination and uncertainty.

The effect of federal taxation of state and local bonds can not be determined exclusively by estimates of the increased interest costs

of bond financing to state and local governments as a whole. Whatever the increased interest cost may be, it will fall far more heavily on local than on state governments, with their larger and more diversified powers of taxation, if future borrowings continue in the same proportions as in the past. Less than one-sixth of present state and municipal gross debt, it will be recalled, is state debt and more than five-sixths is local debt. Many local jurisdictions, moreover, must subsist under tax rate restrictions within which they have difficulty in meeting their present expense, and thousands of water systems and other public service enterprises are operated with service-at-cost rates adjusted to meet the present level of fixed charges. A special and increasingly important segment of state-local activities would stand to be particularly affected by higher bond financing costs — those financed by revenue bonds which are supported exclusively by the earnings of the undertakings themselves. Many of the enterprises thus financed are operated as municipal departments, but an increasing number are under the jurisdiction of a relatively new type of public agency — authorities and special districts with no powers of taxation. This summary might be elaborated to include such items as the effect on earmarked funds for debt service, but it will serve to suggest at least that any increase in interest costs resulting from the taxation of state and municipal bonds might necessitate rather intricate readjustments in revenue systems and might affect the further development of public enterprises capable of only a marginal degree of self-support.

It is largely for these reasons that the immediate effect, and to a great extent the long-term effect, of the federal taxation of state and local bonds would depend on the means of accomplishment. Is it to be by a process of attrition; by general statute followed by supreme court determination; or by constitutional amendment? Is it to be retroactive to apply to outstanding bonds; it is to be reciprocal, with permission given the states to tax the instrumentalities of the federal government and its agencies?

When so important a change in a traditional federal-state relationship is contemplated, it is not only just but is essential to the well-being of the nation that it be made without discrimination and without piecemeal transactions which leave the issue in a cloud of uncertainty. State and local governments are entitled to know clearly where they stand so that they can plan accordingly. This will not be accomplished under a process of attrition whereby through rulings of the treasury department and opinions of the attorney general the courts are called upon to make further distinctions between the taxability of governmental and proprietary enterprises and of public service enterprises managed by municipalities and by special public agencies.

If under such a discriminatory process the income from bonds of authorities and of the public service enterprises of state and local governments should become a special subject of federal taxation there is no question that it would have a detrimental effect on the market for their bonds beyond that which would accrue under general provision for the taxation of state and municipal securities. No investor subject to income surtaxes would be likely to turn to such investments when there remained the option of equal safety in a wide range of tax-exempt securities. The result certainly would not produce federal revenues of sufficient importance to compensate for the protracted litigation and confusion which would ensue, nor for the derangement of plans for the financing of housing, water supply, transportation and other pressing public service requirements.

Whether the issue calls for the laborious method of a constitutional amendment or merely for an act of congress is a moot question. Certainly the latter, while it could be said to reflect the wishes of the public through its elected representatives, would still leave the decision unsettled until it could be fought through the supreme court. It is essential, however, both in the interest of a sound system of taxation and the avoidance of discrimination, that any forthcoming provision apply to all state and municipal bonds alike and that states receive the right to tax the interest of federal bonds.

Retroactive taxation, aside from the considerations of fairness and good faith, would tend to have a detrimental effect on new state and municipal borrowing. Irrespective of the auspices under which federal taxation of income from state and municipal bonds might be ushered in, some shifting of security holdings would occur. With a tax applicable only to future issues, old bonds would in all likelihood sell at such a premium that many holders not interested in the tax-exempt feature would seize the opportunity to dispose of them at a profit. Special funds would thereby be released for the purchase of forthcoming taxable securities which would help to steady the market during a transitional period. Were a federal tax to be applied to income from outstanding securities, however, a quite different and much less tenable condition could be expected. The normal supply of new state and municipal bonds would be augmented through the disposal of low yield bonds by investors in the high income brackets, with the result that prices would be abnormally depressed during the period of such liquidation.

Suppose we assume that a non-discriminatory and complete program for federal taxation of income from all future borrowings of state and local governments is adopted, and then endeavor to gauge the probable effect on the finances and financial policies of the state and local governments themselves. The primary consideration is what would be added to the cost of borrowing — how much more

would states and local units have to pay in interest charges. The precise answer to this vital question must be left to the determination of experience; but this does not preclude an attempt to deflate some intentionally fantastic guesses and to marshal pertinent facts and impartial estimates.

In the first place, only a very limited proportion of the $19 billion state and local securities outstanding is held by private investors subject to a high surtax, and whose holdings, therefore, are likely to be strongly influenced by the tax-exemption feature.

Nearly one-fourth of the gross state and local debt, in fact, is owned by the various governments themselves, primarily in sinking, trust, and investment funds, and therefore not involved in the issue of tax exemption. A recent survey by the Division of Research and Statistics of the U. S. Treasury Department and the Division of State and Municipal Statistics of the Bureau of the Census provides a careful estimate that of $19,298 million tax-exempt securities of state, local and territorial governments outstanding at June 30, 1937, $4,324 million are governmentally owned.

The distribution of the $14,974 million in the hands of the public cannot be traced with any satisfactory degree of precision, but it is likely that close to one-half of this total is owned by corporations and institutions, some of which are exempt from federal taxation and none of which is subject to personal income surtaxes. The treasury department survey located over $6,000 million thus owned, including only partial figures for some classifications.

Banks were found to be the largest corporate holders with $3,600 million, $831 million of which belonged to tax-exempt mutual savings banks. The amount held by life insurance companies, not an entirely complete figure, is $1,424 million. The known figures for other insurance companies, probably representing not more than half of the total, is $322 million. Non-finance corporations are credited with $359 million on the basis of 1935 Statistics of Income, another low estimate. Among the tax-exempt corporations other than the mutual savings banks already mentioned, the fraternal benefit societies representing 75 per cent of the assets of such organizations hold $356 million state and local bonds. Educational, charitable, religious and other non-profit organizations account for smaller but not insignificant amounts.

The search for the holdings of individuals subject to income surtaxes thus narrows to within the roughly $8,000 million still unaccounted for. Federal income tax returns in 1935, according to the treasury department survey, disclosed ownership of only $2,562 million state and municipal bonds by individuals with net incomes of $5,000 and over. The more complete reporting of income received from this source, however, suggests that they held in the neighborhood of $4,000 million of such securities.

It is not till an individual's income reaches $50,000, however, that the yield on a tax-exempt bond becomes one per cent higher than on a taxable bond carrying the same interest rate. And of state and municipal bondholders with net incomes of $5,000 and over probably not more than 38 per cent represent incomes of $50,000 and over. It seems reasonable to assume, therefore, that less than one-fourth of all state and municipal bonds are held by individuals subject to a surtax on income and that less than one-tenth are owned by individuals who benefit as much as a full one per cent in interest yield.

The significant inference to be drawn from these data is that the great majority of the holders of state and municipal bonds bought them primarily for other reasons than tax exemption. Certainly mutual savings banks, fraternal benefit societies and other tax-exempt institutions with large municipal bond portfolios consider purely their quality as investments. Information regarding the investment policies of finance corporations such as banks and life insurance companies carries assurance that they buy state and municipal bonds mainly because of the sound security which they offer.

It is somewhat less than flattering to state and local governments to suggest, as some of the spokesmen for this subject do, that the low interest rates which they enjoy are attributable largely or entirely to tax exemption. Their highly satisfactory security is the main factor in determining their market, combined with the advantages which they offer for diversification and liquidity. Tax exemption is a secondary consideration. In view of their record under adverse circumstances and in view of the factors which enter into their security, state and municipal bonds as a class are entitled to rank above corporate bonds as a class purely on the basis of safety for investment. The highest grade municipals, in other words, possess a greater intrinsic value than the highest grade corporate bonds, and the same relation maintains down through the various categories of security. Surely the bonds backed by the resources of our wealthiest and strongest states have fundamental advantages over the bonds of even our greatest private corporations, and the bonds of a city of well-diversified resources are likely to stand high in comparison with those of the individual business corporations which help to comprise its resources.

The fact that the security of state and municipal bonds for investment is so widely recognized by corporate and institutional investors may be expected to help maintain favorable interest rates for them in the event they become taxable. Any noticeable increase in interest levels will bring in more corporate investors and tend to attract more small private investors. And individuals with large incomes are not going to overlook the security offered, merely because the abnormal advantage of tax exemption is removed.

How much would interest rates be affected by the elimination of tax exemption? Estimates run as high as 40 or 50 per cent, but they would be difficult to justify. Mr. Bernard Knollenberg, writing in the October number of *Harpers Magazine* on "The Supreme Court and Tax-Exempt Income," estimates a more modest 15 per cent, and this is supported by two or three other estimates from well-informed sources which do not exceed 17 per cent.

Approaching the problem directly, it seems reasonable to assume that the increased interest cost to state and local governments would not be more than the federal government would gain in income tax revenue. This assumption has support in the only extensive published study of the subject, that of Mr. C. O. Hardy of the Brookings Institution in 1926. Professor Roswell Magill, former under secretary of the treasury, writing in *The Tax Magazine* for December, 1937, said ". . . the best information which we have available leads us to estimate that if the federal government were authorized to collect federal income taxes upon the interest on state and local bonds outstanding, the additional revenue at current levels of income and under the provisions of the present revenue law would be approximately $70 millions annually." If the assumption is correct that the increased interest cost to state and local governments would be no more than the federal gain in income, that increase would be no more than 10 per cent, as Professor Magill's figures were predicated on an estimated annual interest charge of $718 million.

Suppose, in order not to draw the lines too fine, we take the higher 15 per cent estimate and see what it would signify for state and local governmental costs. If outstanding debt had been issued without the tax exemption provision, the interest charge last year would have been increased by $93 million. This is based on the treasury department's recent estimate that the net interest exempt from federal income taxes was $620 million. The effect would have been to increase the over-all state and local government expense of $7,000 million about 1.3 per cent.

In the event of the elimination of tax exemption, not even any such relatively small increase in expense, of course, would be felt immediately, but would accrue gradually over a long period of years as new taxable securities took the place of tax-exempt securities. Thus the effect on the aggregate of state and local budgets certainly should not be disrupting or disturbing.

There is the probability, however, that the percentage of increase in interest costs would vary for different classes of securities. The highest grade credits, being luxuries that are particularly sought after by persons in the high income brackets (because under tax exemption they still produce better than taxable securities), in all likelihood would be affected the most. The bonds of the general

run of smaller, less widely known political subdivisions would probably be affected less than the average because they are absorbed largely by local banks and small investors, fraternal benefit organizations and some insurance companies. Some new public service projects, particularly those financed by revenue bonds, might be handicapped by the withdrawal of the tax-exemption feature.

If the states should also secure the privilege of taxing federal bond interest, an arrangement which would be an essential part of any equitable plan, there would be some compensating return. There seems to be general agreement, however, in view of the low scale on which the states tax income, that the states would be the net losers.

The discussion thus far has been directed to show that federal taxation of the income from state and municipal bonds, if imposed upon all without discrimination, would not be likely to have any material effect on interest rates, would not have any perceptible immediate influence on the budgets of established units of government, and would not, even in the long run, add any notable amount to the cost of government.

Certain advantages for state and local governments have, as a matter of fact, been advanced. One theory, emanating from a number of sources, is that taxation of the income from the bonds of states and municipalities would be a strong influence for economy. That is, because it cost more to borrow, less borrowing would be done and state and local governments would be much more careful to pay their way from current revenues. Even if it should cost noticeably more to borrow by means of taxable bonds, which does not appear to be a reasonable anticipation, the theory that borrowing would be discouraged has little basis in the borrowing record. The heaviest waves of municipal borrowing in the past have been without much regard for the level of interest rates, and have accompanied business and building booms in which competition for money has resulted in abnormally high interest charges. On the other hand, the great majority of municipalities are now borrowing below normal, despite the facts that interest rates are extraordinarily low, there are many emergency financial requirements, and the federal government is exerting pressure for borrowing through generous grants in aid. Past experience appears to indicate that state and local governments borrow excessively when their people are in a spending state of mind, and that they are not deterred by interest costs.

There is, however, one advantage of great potential value to be derived from federal taxation of income from state and local bonds. The various governmental borrowers would be forced to emerge from the smoke screen of tax exemption and to seek a market for their securities solely on their intrinsic merits as investments. This

would call for much better financial reporting than is presently forthcoming from the average governmental unit, and it would also be an incentive for more consideration by public officials of the principles and standards of credit. Since good credit is closely related to the maintenance of sound fiscal policies, the movement for better managed government would receive additional impetus.

It is probable that the promotion of new public service enterprises of marginal earning power would be somewhat handicapped by the abandonment of federal tax exemption for their bonds. Such exemption, however, is nothing but a concealed subsidy. If such subsidies are necessary it is far better policy that their necessity be clearly known and that there be opportunity for consideration of the desirability of such undertakings on the basis of their actual cost.

In conclusion, the probable effect on state and local governments of federal taxation of their bonds can be summed up very briefly. So long as the transition is equitable and clear-cut, without discrimination and uncertainty, there is nothing to arouse concern. There should not be any material increase in interest rates, the immediate effect on the budgets of most governmental units will be negligible, and the long-term costs will add only fractionally to their over-all expense. State and local governments will be encouraged to improve and publicize their credit standing, and concealed subsidies to public service undertakings will be brought out in the open where they can be considered on their merits. The chief consideration, therefore, will be the progress made toward a sound tax system for the country as a whole.

Chairman Gerstenberg: Well, I am sure you will agree with me that that was a very interesting and informative paper—not very much law, but replete with economic facts.

We have finished the papers under the twenty-minute rule, and we now pass to the discussion under the seven-minute rule. The first speaker under the seven-minute rule is Mr. Henry Hart, of the First of Michigan Corporation, of Detroit, a corporation dealing in municipal bonds. Mr. Hart was at one time chairman of the Investment Bankers' Association committee on municipal bonds.

Mr. Hart!

Henry Hart (Michigan): We have been privileged to hear tonight able discussions on this increasingly important subject by a professor of law, the chief counsel of the internal revenue department, and one of the outstanding authorities in the country on municipal credit. The program committee has been good enough to give a dealer in municipal securities a few minutes to say something on this subject. Perhaps the program committee recognized the fact that this group which I am supposed to represent is somewhat on the spot these days, because we have been selling securities

to investors on the representation that they are free from federal income taxes. We of course endeavored to protect ourselves by stating "on opinion of counsel."

It is interesting to note that notwithstanding the president's message of last April, the recent supreme court decisions, and the exhaustive study of the department of justice, plus able remarks from the chief counsel of the internal revenue department, that we are still being advised by the outstanding municipal bond attorneys of the country that the honds we are selling are free from federal income taxes.

Aside from the fact that we are relying on the opinion of counsel, we of course recognize a certain moral obligation to our customers who have been willing to take a smaller return on their investments in consideration of the privilege of tax exemption, which an overwhelming authority heretofore has considered guaranteed to them under the constitution of the United States as interpreted by the supreme court.

If the problem only involved the taxation of future issues of government and municipal bonds, we would have little to worry about so far as our customers are concerned. Most of us, in fact, have no quarrel with the social arguments that are presented against tax exemption. In fact, from a selfish point of view, and laying aside for the moment the increased problems on states and municipalities, we would welcome such a tax, providing it could be done by constitutional methods. As Dr. Bird has mentioned, it would broaden the market for municipal securities, and would open a new source of business to us, in permitting us to purchase the tax-exempt bonds from customers who no longer need the tax exemption, and putting in their place the higher yield bonds of future issues of taxable bonds.

But we could derive no comfort from a program such as has been outlined by Mr. Wenchel of attempting to tax future issues by congressional action alone. I believe that every argument that he presented in support of the legality of such a tax would apply with equal force to the taxation of outstanding municipal bonds. If they can do the first step legally, we would have no assurance that they would not take the second step.

As has been mentioned, it is perfectly obvious that new sources of revenue are needed and will be sought after by the present administration. It is likewise apparent that the taxation of future issues of municipal and government bonds will add little to the government tax revenue for many years. Dr. Bird has pointed out that less than 25 per cent of state and municipal bonds are held by parties subject to a substantial income tax. I think his figures and others that have been prepared would show that less than 50 per

cent of the outstanding municipal bonds would be subject to any federal income tax.

Assuming that $1,000,000,000 of new state and municipal bonds are issued each year at an average interest rate of three per cent, there would be only $30,000,000 income on such bonds, and 50 per cent of that figure as the amount that would be reached by federal income tax would only be $15,000,000.

But if outstanding issues were to be taxed the story would be different. Dr. Bird has given one figure of $718,000,000 as the annual interest paid by states and municipalities. Even if we reduce this by 50 per cent as the interest on outstanding municipal securities which could be reached by federal income taxes, there would remain over $350,000,000 which might be taxed, a figure considerably different from the $15,000,000 which might be taxed on future issues only for several years to come.

The government might properly plead as to newly issued bonds that it has no contractual relationship with the holder of a municipal bond. But that relationship does exist in connection with presently outstanding government bonds. If it recognizes that relationship as to its own bonds, and confines its attempt to tax government bonds to future issues, we probably will not be worried about the increased cost of borrowing; the Social Security Act provides substantial government funds to absorb the future issues of government bonds.

CHAIRMAN GERSTENBERG: This afternoon at one of the round tables Mr. Fernald presided. When he was asked to preside he said that he would do it in spite of the fact that it would require that he take a plane out of Detroit to keep a previously arranged engagement on the west coast. He said he didn't care very much about flying across the Rockies but he would do it, and he did it.

I learned from Mr. Query just now that Mr. Studenski of New York believed that his talk would occur tomorrow night. When he learned this morning that he was scheduled for tonight he jumped on a plane immediately and came across the Alleghanies. It is a great tribute to the National Tax Association that men will make such efforts to contribute to its work.

Dr. Studenski, will you come along now and please talk on this subject for seven minutes, or any length of time you wish?

PAUL STUDENSKI (New York): I shall address myself to a discussion of Mr. Wenchel's paper, although I should have liked to say a few words about my complete accord with the very admirable paper of Mr. Bird.

FEDERAL TAXATION OF STATE AND MUNICIPAL BONDS

PAUL STUDENSKI
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The question of reciprocal federal-state taxation of interest on federal, state and municipal obligations is of much greater concern to the federal, than to the state governments. First of all, the federal government is dependent for a larger proportion of its revenues on the income tax than is any state. Many states, in fact, levy no income taxes whatsoever and therefore, for the time being at least, have nothing to gain from such reciprocal taxation. Secondly, the inducement for taxpayers to invest in tax-exempt bonds so as to reduce their taxes results mainly from the high surtaxes of the federal income tax. The consequent losses in revenue are, therefore, sustained mainly by the federal government. Thirdly, the federal government grants only a partial tax exemption for most of its own obligations, whereas state and municipal bonds carry a complete exemption from the federal tax. As a result of this complete exemption, states and municipalities can borrow money at somewhat lower rates of interest than they otherwise would have to pay and the obligations of some of the states and municipalities sell at a higher price than comparable obligations of the federal government. The yields on these state and municipal issues are actually lower than the yields or corresponding federal bonds.[1] Thus, the states and municipalities gain at the expense of the federal government, which loses revenue far in excess of any gain it procures in lower costs of borrowing.

Today wealthy individuals invest their funds in tax-exempt state and municipal bonds as a convenient refuge against the high surtax rates of the federal income tax. The immunity of state and municipal bonds from taxation thus seriously undermines the federal powers to tax and interferes, therefore, with the operation of our constitutional system. It is difficult for a layman to understand why this effect of tax exemption in undermining the federal taxing powers and, hence, our constitutional system, is not being given proper consideration by our legal authorities in their discussions of the constitutional issues involved in the subject.

It is proposed that the federal government should tax, under its income tax, interest on all future issues of state and municipal

[1] Thus, for example, in October, 1938, a New York State bond maturing in 1945, bearing interest at 2½% and carrying complete exemption from the federal income tax was yielding at its then existing market price, 1.20%. A federal bond of comparable maturity, which was only partially exempt, was yielding 1.58%.

bonds, that the states should tax under their income taxes, interest on all future issues of federal bonds; and that both the federal and the state governments should tax under their respective income taxes interest on the future issues of their own bonds and the bonds of their respective agencies or subdivisions. It is generally conceded that both the federal and the state governments are under a moral and in many cases also legal obligation to continue the existing exemption of interest on outstanding issues. It is obvious that the subjection of state and municipal bonds to the federal income tax constitutes the most important part of the entire proposal because of the constitutional issues involved. The moment the problem of tax exemption of state and municipal bonds from the federal income tax is disposed of, the problems involving the taxation of other types of government bonds under federal and state income tax laws can easily be solved.

Some citizens insist on the continuance of the existing reciprocal exemptions of state and municipal bonds from federal and state taxation because it benefits their particular state or municipality. The fact that these exemptions have evil consequences for the country as a whole seems to concern them little. Obviously, such a narrow local approach to a policy which has broad national implications, is utterly inappropriate.

Most people who have given any thought to the subject of exemption of government bonds from income taxation fortunately are inclined to view it from a broader point of view. They agree that the exemption has bad financial, social and economic effects and should be terminated as speedily as possible. They disagree among themselves only with reference to the best method of accomplishing this result. It is conceded generally that tax exemption results in heavy losses of revenue to the federal government, that it diverts the flow of capital from private industry and hence retards industrial growth, that it permits some citizens to escape their proper share of the costs of government, and that it invalidates the ability-to-pay principle of taxation to which we, as a democratic people, are presumably committed. The truth of these contentions can hardly be denied. Ten to twenty years ago, the exemption of interest on government bonds from the federal income tax was quite commonly defended on the ground that it produced savings for the government in the form of lower interest charges, far in excess of losses in revenue. Today this argument can no longer be seriously advanced, for the fact that tax exemption under present-day conditions produces the opposite effect is too easily demonstrated.

Some people defend tax exemption on the ground that the present high surtax rates of the federal income tax are confiscatory in character. It is fortunate from a public point of view, they say, that this escape from discriminatory taxation is open to the wealthy taxpayers. This is a dangerous argument. It places a stamp of ap-

proval on a perversion of the law. For no one would contend that the exemption from income taxation of the interest on government bonds was ever intended to provide such a refuge to wealthy taxpayers. The proposition that the income tax be so perverted, is obviously contrary to the fundamental principle of our democracy that the laws should be obeyed by citizens, even though individually they may take exception to them.

Some lawyers contend that the federal government has no power to tax the receipts from interest on state and municipal bonds. They propound the doctrine of the constitutional immunity of the interest on such bonds from federal taxation, tracing it to the John Marshall's famous decision in which the immunity of a federal instrumentality (a branch of the Bank of the United States) from state taxation (which was discriminatory in character in this case) was held essential to the preservation of the independence of the federal government. It is asserted by these jurists on the basis of this decision and also of the Pollock decision of 1894, that the immunity of the interest on state and municipal bonds from federal taxation is necessary to the preservation of the independence of the states. To an ordinary layman this contention seems fantastic. The writer has never yet heard a layman, however opposed to the proposal to tax the interest on state and municipal bonds under the federal income tax, seriously contend that such taxation would undermine the independence of the states.

Since under the proposal, interest on state and municipal bonds would be taxed under the federal income tax in exactly the same manner as interest on federal bonds, such taxation of interest on state and municipal bonds could not possibly impair the borrowing powers of the states and municipalities without interfering at the same time and in the same manner with the borrowing powers of the federal government. If at any time, however, the opposite holds true and the federal tax in question should become discriminatory in nature, as regards state and municipal bonds, appeal could be had to the supreme court. That the supreme court would not allow such discriminatory taxation, can scarcely be doubted. It is clear, therefore, that ample protections against the improper usage of federal taxing powers in the matter, exist in our constitution and that there is no need for making the interest on state and municipal bonds immune from any federal taxation to make these protections effective. The contention that interest on state and municipal bonds must be kept immune from federal taxation in order to preserve the independence of the states is in complete discord with the actualities of our political system. It represents a purely legalistic and round-about approach to a very simple and practical problem.

Recent papers by Mr. John Philip Wenchel, chief counsel to the Bureau of Internal Revenue,[2] and the careful researches conducted into the subject by the department of justice during the past year or two [3] clearly establish the fact that the doctrine of immunity of state and municipal bonds from federal taxation which so palpably offends common sense can scarcely be considered to be the law of the land. It is shown that this doctrine is embodied only in the Pollock decision referred to above, and that this decision has been superseded by the sixteenth amendment. The amendment is shown to have negated this decision not only as regards the apportionment of the income tax among the states according to population, but also as regards the non-taxability by the federal authorities of interest on state and municipal bonds. It is shown by these researches that the phrase of the sixteenth amendment giving congress the power to tax income "from whatever source derived" was inserted therein for the specific purpose of removing the aforementioned restrictions of the Pollock case, and that it was commonly understood in and out of congress at the time to be aimed at the accomplishment of this result.

Says the report of the department of justice on this point: [4]

> "There is certainly nothing that was said in the course of this debate [in congress, on the resolution submitting the constitutional amendment] from which it may be inferred that a single member of the congress expected, or intended, that the income from state and municipal bonds, and the salaries of state and municipal officers and employees, should be constitutionally immune under the proposed amendment. On the other hand, every positive utterance in the course of the debates is susceptible of the construction that the congress did not intend to grant any form of immunity."

No less of an authority than Chief Justice Hughes, at the time he was governor of the state of New York, in transmitting the proposed amendment to the legislature, warned the legislators that the phrase "from whatever source derived" would extend the federal taxing power to income from interest on state and municipal bonds and income from state and municipal salaries. Mr. Wenchel says in the paper already quoted: [5]

[2] Address on the "Legal Aspect of Tax-Exempt Privileges," before the American Bar Association, reprinted in the *Congressional Record*, May 25, 1938, no. 107, p. 9908-9911; and address on the "Federal Taxation of State and Local Bonds," before the National Tax Association, October 24, 1938.

[3] "Taxation of Government Bondholders and Employees. The Immunity Rule and the Sixteenth Amendment. A Study Made by the Department of Justice." Government Printing Office. 1938. 219 pp.

[4] *Ibidem*, p. 161.

[5] See footnote 2, above.

"Senators Borah and Root disagreed with Governor Hughes. Nevertheless, Governor Dix, who succeeded Governor Hughes, urged the legislature of New York to ratify the sixteenth amendment in these words:

"'Indeed, it seems to me that if the words 'from whatever source derived' would leave the amendment ambiguous as to its power to tax income from official salaries and from bonds of states and municipalities, the amendment ought to be opposed by whoever adheres to the democratic maxim of equality of laws, equality of privileges, and equality of burdens. It is impossible to conceive of any proposition more unfair and more antagonistic to the American idea of equality and democratic principle of opposition to privilege, than an income tax so levied that it would divide the people of the United States into two classes.'

"The construction placed upon the proposed sixteenth amendment by Governor Hughes received wide publicity throughout the country. This belief was held and strongly expressed by many lawyers and public officials. It was referred to and discussed in the messages of a number of governors in submitting the proposed amendment to the state legislatures. For example, the governors of Florida, Missouri, North Dakota, and Oklahoma all agreed with the interpretation of Governor Hughes that the sixteenth amendment extended the taxing power, but nevertheless they urged its ratification. From these sources it seems clear that a large number of supporters of the sixteenth amendment believed that they were conferring upon the national government the power to subject the interest from state and municipal bonds and the salaries of state officers and employees to an income tax."

When therefore congress, after the adoption of the sixteenth amendment, in enacting its income tax law inserted in it a provision exempting from the tax interest on government bonds generally, it did so apparently for reasons of expediency rather than because of any conviction that such exemptions were required by the constitution.[6] The supreme court has never had an opportunity, since the adoption of this amendment, to pass on the powers of the federal government to tax interest on state and municipal bonds under its income tax. The evidence presented by Mr. Wenchel[7] and the department of justice gives support to the belief that the supreme court will sustain these powers, and that congress can, therefore, provide by a simple amendment of the federal income tax law for

[6] *Ibidem*, p. 192.

[7] As quoted by Mr. Wenchell, *Congressional Record*, vol. 83, no. 107, May 25, 1938, p. 9911.

the taxation of the interest on all future issues of state and municipal bonds.

Some people believe that even though the federal government may have the power to tax the interest on such bonds, it would still be safer to do so by a constitutional amendment. This reasoning seems to us to be palpably weak. The most effective answer to this contention was given by Mr. Nicholas Murray Butler, president of Columbia University, a year ago in the following statement.

> "There could be no more direct and unqualified grant of power to congress to tax income from whatever source than is contained in the language of the sixteenth amendment. To adopt now another amendment definitely specifying that the congress might tax income from sources which have been held exempt because of court decisions subsequent to the sixteenth amendment would be to make us the laughing stock of the world. That would be equivalent to saying that the words 'from whatever source derived' do not mean what they appear to mean, but must be supplemented by a variety of specific designations of sources of income. Out of this situation would arise a new series of court decisions which would exempt the income from sources not specified in the second amendment. The situation would be ludicrous to the point of absurdity."

A fear is expressed by some people that the subjection of the interest on future issues of state and municipal bonds to federal income taxation would result in a material rise in interest rates on such bonds. Undoubtedly some rise in interest rates on such new issues would result. But this rise would probably not exceed one half of one percent and would be of little immediate consequence, inasmuch as the volume of new issues would be relatively small. Years would go by before the volume of tax-exempt state and municipal bonds would diminish so materially as to vitally affect bond prices and bond yields in the market generally.

To summarize, the present exemption of the interest on state and municipal bonds from federal income taxation is creating an intolerable situation. Steps should be taken immediately to bring about the termination of the exemption at least so far as new issues of state and municipal bonds are concerned. Congress should pass an amendment to the federal income tax law making interest on such bonds taxable. A test case should then be instituted at the earliest possible time, which would enable the supreme court to pass upon the constitutionality of the measure. This, in the main, is the program which has the backing of the president of the United States. People interested in fair taxation have been complaining for years of the evil of tax-exempt bonds. They have now an opportunity to lend their support to a reasonable program for a gradual elimination of this evil.

W. E. Kershner (Ohio): Many government reports have been made recently on this subject, practically all of them dealing with the constitutional and legal phases of the question. The president has suggested the passage of the law, and if congress passes it and the supreme court pronounces it constitutional, the legal phase is settled. Since congress will either pass it or not pass it, and since one guess is as good as another on the action of the supreme court, no amount of discussion now of its constitutionality is worth while. Very little has been said, however, about whether the proposal is right or wrong; whether it is fair or unfair to the states and municipalities; and what will be its effect upon local taxing districts.

Federal taxes on the income from state and municipal bonds will *raise the interest rates* and since interest on bonds is paid by *local real estate taxes* in most cases, it simply means an increase in the taxes on real estate to pay an increased interest rate in order that the federal government may collect the increase from the holders of the bonds. During the last few decades the federal government has continually broadened its field of taxation until local governments and schools are being starved, but it has never before made a serious effort to tax real estate. If it can tax real estate, then it has usurped practically the entire field of taxation and nothing would prevent it from requiring all taxing districts to send a certain percentage or the entire amount of the local tax collections to the government and then depend for local services upon the return of whatever a benign federal government thought wise or necessary or expedient.

In one Ohio city certain bonds issued prior to 1913 and therefore free of all taxes, state and federal, sold recently on a 1½% yield basis. Similar maturities of the same city issued since bonds were taxable in Ohio now sell at a yield of from 2% to 2½%, and the only tax on these bonds is the intangible tax of 5% of the income. It will be noted that the spread is greater than the tax. This is due to the fact that Ohio might increase the tax at any time and the investor in these long-term bonds must take this possible increase of taxes into consideration. It is very evident then that a federal tax on the income of municipal bonds will increase the interest rate more than the tax since any congress would have the power to increase the tax, and an investor buying long-term bonds at a certain rate of interest with a certain tax at the time of purchase would not know what some future congress might do in the way of increasing the tax, and he would of necessity take this into consideration in making the investment.

Ohio bonds issued prior to 1913 were tax free. After that they were taxable in Ohio, and until an amendment to the constitution was adopted providing for classification of property, were taxable "at their full value in money." The result was a decided increase in interest rates. In 1921 the city pension systems in twenty-two

Ohio cities merged with the state teachers' retirement system, transferring assets and liabilities on an actuarial basis. Among the assets were bonds issued prior to 1913. These were sold on bids and the proceeds invested in new, taxable bonds at an increased rate of interest of 2%. This spread of 2% in income between tax-free and taxable bonds gradually reduced as the state made no adequate effort to collect this tax on them. About the only time it was ever collected was when the owner dropped dead and the bonds were found in his safety-deposit box. The ease with which this tax could be evaded gradually decreased the spread, and with the passage of the intangible tax law the evasion gradually stopped because the tax wasn't enough to justify the risk, but a spread of from ½% to 1% still continued as noted in the case of the Ohio city mentioned above.

If municipal bonds are made subject to federal taxation and there are no exemptions, then retirement system funds for teachers and public employes, workmen's compensation funds and endowment funds of colleges and institutions would be subject to the tax. It would simply mean that teachers and public employes and the public would be obliged to make additional payments to make up the tax, or the employes receive less at retirement. It would mean that every employer would have to pay a higher rate for workmen's compensation or the workmen would receive less. It would mean that the endowment funds of colleges and institutions would not yield as much and the difference would either have to be made up or services curtailed. It would mean that insurance companies would have to reduce dividends or increase premium rates. The best posted investment bankers in Ohio agree that 80% at least of Ohio bonds outstanding are institutional holdings, but if these holdings are exempted from the operation of the tax, then the interest rate will be raised on all bonds issued just to punish a few rich holders of municipals.

The real truth of the matter is that there are no bonds not subject to taxation. If a city can issue 3% bonds tax free and must issue 3½% taxable bonds, and if the owner of the bonds is required to pay the ½% in taxes, he still has 3% net and the only effect is to make the real estate taxpayers of the city pay ½% more interest to the federal government through the owner of the bonds. It would be much better for the city to pay only 3% and save the ½% for itself, and certainly this reduction of ½% in interest above the tax-free rate is a tax that the owner of the bonds saves to the taxing district issuing the bonds, and the source of the bonds receives the benefit instead of an outside taxing power. The whole proposal is absolutely wrong and unjust and is simply an effort on the part of the federal government to extend its field of taxation to real estate to the detriment and possible ultimate destruction of local government.

In the report of the committee on debt adjustment of the Twentieth Century Fund two statements are made that are curious. One statement is that tax exemption of federal, state and local government securities "make it unhealthily easy for governmental bodies to go into debt." In the last eighteen years, during which time we have purchased about $250,000,000 Ohio bonds, we have failed to see any difference whatever in the amount of bonds issued due to higher or lower interest rates. This year a large number of bond issues were voted but certainly not because the interest rate is low. The universal argument used in securing the passage of these bond issues was that the community would be obliged to help pay the bill for P.W.A. and might as well grab off whatever it could or it would go to some other locality. Many small places were encouraged by the federal government to issue bonds for waterworks and sewerage systems which will be extremely difficult, if not impossible, for these local communities to pay. The way to make it "healthily difficult" for governmental bodies to go into debt is simple. Elect a congress pledged to stop the increase in the federal debt and make it difficult to issue local bonds. In Ohio a bond issue requires a 65% vote, and practically the only loosening of this restriction has been at the suggestion of the federal government in order that communities might be induced to take advantage of federal grants. This report continues with the assertion that this exemption also makes "debt investments too attractive to wealthy people who can best afford to run the risk of direct ownership in stocks, real estate and other equities." By what method of reasoning does anyone conclude that making a safe investment unattractive will induce people with no knowledge of business or those in charge of trust funds "to run the risk of direct ownership in stocks, real estate and other equities"? The whole argument resolves itself into the question of whether local districts will stand for federal taxation of local taxes and thus further decrease local governmental services in which every person is vitally interested. And I might add that people generally still have some appreciation of the value of local government.

I have not time to discuss the other phase of this subject—the income tax extension to state and local employes, including teachers. This again involves the federal taxation of local taxes. The federal government has a right to apply the income tax law to its own employes. It fixes and pays their salaries. If it wishes to pay them more than their worth and compels them to return part of it, well and good. The state has the same right regarding the taxation of its employes if it wishes to do so. Federal salaries are fixed with consideration of the income tax in mind. In fixing salaries of state employes, the federal income tax is not taken into consideration. One pays an employe $4000 a year and requires him to

return $200 and the other pays him $3800 and avoids the bother of collecting the $200. If state income taxes are levied on the salaries of federal employes their salaries may easily be increased to meet the new state tax, just as Mr. Knollenberg in the October *Harpers* suggest for federal judges. State and local salaries will be very difficult to raise, and they have been fixed on the exemption basis. The salaries of teachers will not be raised at all except possibly the small class of teachers who have become educators.

CHAIRMAN GERSTENBERG: I recognize Mr. Brown.

ROBERT C. BROWN (Indiana): Mr. Chairman, there are two problems that seem to me rather serious here. I am in accord with the general idea of doing away with these tax exemptions on both sides. But there was one point raised by Mr. Hart: if it is constitutional, contrary to all the ideas of the supreme court up until recently, for the federal government to tax municipal bonds, why shouldn't the federal government tax existing bonds as well as future bonds, and what in the world is to prevent a future congress from doing it? That is one thing.

The other thing is the point that Mr. Rottschaefer raised; apparently there isn't any limitation upon congress exempting federal bonds, and what is to prevent a future congress, even though the present one subjects federal bonds to state taxation, from calmly exempting some or all of the federal bonds from all taxation?

For those reasons it seems to me that the proper thing to do is to have a constitutional amendment which will tie them both up and require each branch of the government to permit the other side of the picture to tax its bonds in the future.

MR. ROTTSCHAEFER: May I say, in response to that, that I didn't read to the conference the last paragraph of my paper, and the last of your statement was in substantiation of the remarks in my last paragraph. That is what I thoroughly believe in. If we are going to do it—and I took no position on the question as to whether we ought to or whether we ought not to—the thing to do is to get a constitutional amendment that will bind congresses of the future to maintain an equivalence of power and privilege between the states and the federal government in this matter.

I don't want to see an all one-sided affair. I don't consider even that all socially-minded persons need not contend that the national government should have it all its own way.

CHAIRMAN GERSTENBERG: Is Mayor Reading here? Mayor Reading told me just before noon that he was hoping to be able to get over here this evening because he wanted to say something on this subject. Perhaps somebody knows his viewpoint.

RAYMOND H. BERRY (Michigan): The mayor is leaving tonight, so I was advised a few minutes ago. He may not be here. If I may have the floor for a moment I will not attempt to speak for the mayor, but I do know some of the ideas in his mind on this very subject. I will speak for myself.

As I see it, this question of taxation of municipal bonds really divides itself into two questions. From the standpoint of revenue purposes, the states, the cities and the municipalities require money. If it is going to cost us more money to issue taxable securities, the revenues of the municipalities must suffer. If, on the basis of equity, we are going to remove exemptions—I am not saying this should be done, but it does raise in my mind a question—then by the same token should we not remove federal property from the exempt rolls—post offices, automobiles, gasoline, sales tax, and the federal housing projects?

On the basis of equity and on the basis of exemptions, it seems to me that if we are going to change, then we should remove all exemptions.

I think the mayor would probably have said the same thing.

CHAIRMAN GERSTENBERG: Has anybody else any viewpoint on this subject?

ROY G. BLAKEY (Minnesota): I am a layman. A layman shouldn't speak on an occasion of this kind, I suppose, when the lawyers have the floor, but I think this is primarily a political and social question. I don't think anybody will endeavor to prove that it will make a great deal of difference so far as revenue is concerned. A great many people have asserted that, but I don't think anybody has proved it, or nearly proved it.

It strikes me that the supreme court could very well have made a line of decisions providing against discriminatory taxation either way. But it didn't do that. So we have a very uncertain situation.

For my part, I would like to see these exemptions generally removed. I think Mr. Berry might have added that if the federal government is going through with that policy, it might remove from exemption even the public lands and everything it owns. A good deal more is involved than most of us think about, if we are going to do this in a consistent way and not do it by patchwork.

If I were a large investor in government bonds, I would much prefer to have bonds non-exempt. Of course, I would like to have advance notice instead of waiting until after I had bought them. But the general popular feeling could not then exist that I was escaping taxation. As a matter of fact, I don't think the holders of tax-exempt bonds are escaping taxation, except in a minor number of cases.

If you read the history of the adoption of the sixteenth amendment carefully, as I have read it, you will find that all that the

sixteenth amendment and its proponents attempted to do was to remove the disabilities that were brought about by the decision in *Pollock* v. *Farmers' Loan & Trust Co.*

Those familiar with that decision know the protest that Governor Hughes of New York, now the chief justice of the supreme court, made against the ratification of the sixteenth amendment, and you know the answer that Mr. Root, who is considered the ablest lawyer of his time, gave to Mr. Hughes' objection. I think the senate went largely on the advice of Mr. Root. Mr. Root and those who agreed with him were very anxious that the sixteenth amendment be very narrowly construed. So I think that the words "from whatever source derived, without apportionment according to population" were intended merely to permit the taxation of income, and special kinds of income, too, without coming under that provision of the constitution which requires that direct taxes must be apportioned according to population.

It seems to me the history on that is fairly clear and that it does not bear out the contentions of Professor Studenski and the others who take his point of view. I may be wrong, but that is my personal opinion.

HENRY F. LONG (Massachusetts): These are just some observations that are neither legal nor even sensible, but they may throw a little light on the subject. First, to Mr. Kershner, I suggest that he go back to Mr. Rottschaefer's discussion in regard to the Gerhardt case, and have more concern for his teachers in respect to the possibility of their being taxed on their pensions; they will suffer a great deal more from that than they ever would by taxation of the funds which are used in order to make their pensions certain.

In regard to Mr. Berry, I might suggest that undoubtedly if the mayor of the city of Detroit carried his objectives to the extreme, it would be dangerous for a warship or cruiser to anchor off Detroit here in the river because they might be taxed ad valorem on the taxing day.

Also, in respect to the intangible property, I don't see any reason why, if we are going to be permitted in our states to tax the federal government issues, if there is reciprocity between the two under dual form of sovereignty, why all of us in the income tax states wouldn't do well to turn from income to ad valorem on intangibles. So that if the intangible in the form of a federal bond is good to yield one and a half per cent and we have a $50 per thousand tax, then we will accomplish what Mr. Kershner wants to enact in Ohio because we will discourage the issuance of government bonds altogether, because the tax in the states would be three or four times what the income would be on the federal issues.

JAMES A. COSGROVE (District of Columbia): I just wonder how many of us stop to think how this question arose. Removing the

immunity from taxation on government obligations and state obligations arose first in government departments. It has been brought before all the meetings by some representative of the government. Does it dawn on you gentlemen that the federal governmnt may dispense with the immunity, the taxation of government bonds for future issues, by a simple enactment of the legislature, whereas, on the other hand, each individual state may provide for doing away with the immunity to the individual state's obligations by a simple act of its legislature? So that this whole problem can be solved by one simple act of our congress as to government bonds and obligations and by 48 separate distinct acts of each of the state legislatures. So to resolve it back, if it is a desirable thing, it can best be accomplished by a constitutional amendment that requires only three-quarters of the states and not 48 states.

CHAIRMAN GERSTENBERG: Is there any other discussion? If not, Mr. Leland wishes to make some announcements.

CHAIRMAN LELAND: The first thing I want to announce is the fact that Judge Zoercher tells me it is past his bedtime. I think you have been mighty patient today. I think this session furnishes the judge with a good excuse for having been up three-quarters of an hour longer than usual.

Tomorrow night we have a dinner and a discussion of some of the major tax problems of industry. A part of the problem of running this convention successfully is that the hotel shall be able to take care of your requirements and to feed you the kind of food you would like to eat. That being true, it is highly desirable that you purchase tickets in the morning at the registration desk for the banquet in the evening so the hotel will have an idea about how much fresh food to cook so that what they had left over from yesterday will not have to be used to meet the excess requirements.

The second thing is the fact that the dinner, like everything else, will start on time—at six-thirty. So much for that. We will appreciate your cooperation on this, and I trust that the service and the evening will satisfy all of your desires.

The next thing I want to call to your attention is the fact that the states are supposed to pick out members of the resolutions committee. Each state is entitled to not more than one member, and such states as do not designate a member by this time tomorrow night will have one picked for them, in case I exercise that prerogative.

The other thing that I want to call to your attention is this: this evening a number of people asked me how they could get copies of these papers and this discussion. Well, for the benefit of those who didn't ask me and who may have wondered about that, there is only one way, and that is by becoming a member of the association

and planking down $5, which entitles you not only to a copy of the *Proceedings*, but to the *Bulletins* of the association.

If anybody wants to announce a political caucus for the selection of resolutions committee delegates or any other purpose, he is quite welcome to the floor before we adjourn. There are four corners in this room and many other spots in which they can meet.

CHAIRMAN GERSTENBERG: May I suggest the New York people meet near the piano?

CHAIRMAN LELAND: There being no further caucuses to be held, I declare this meeting adjourned. We will begin promptly tomorrow at nine-thirty in the morning.

(The meeting thereupon adjourned at ten-forty o'clock.)

FIFTH SESSION

TUESDAY, OCTOBER 25, 1938, 9:30 A. M.

CHAIRMAN LELAND: Mr. Query has some announcements he would like to make before we begin. If he doesn't announce the right things, I have some more that I will announce.

SECRETARY W. G. QUERY: I have been requested to announce that the Oklahoma delegates will meet in Parlor K at 12:30 today for the selection of the Oklahoma member of the resolutions committee.

CHAIRMAN LELAND: I want to call to your attention the fact that we are having a dinner this evening and that it is advisable for you to make a reservation and get your ticket this morning, so the hotel will be able to make a better estimate of our requirements.

I want also to tell the men that we would like to have the ladies at this dinner, as at all other dinners, and that they are most heartily welcome.

This morning it gives me a great deal of pleasure to present as our presiding officer Mr. John Fagan, chairman of the Michigan Tax Commission. Mr. Fagan is a newcomer among us but a man who has, in his short chairmanship of the Michigan commission, given a most excellent account of his time, done a great many important things for the state, and it is with a great deal of pleasure that I present him. I hope that you who have seen him for the first time will take advantage of the opportunity to get acquainted with him, because he is not only a good public officer, but he is a fine gentleman to boot.

Mr. Fagan!

JOHN FAGAN, presiding.

CHAIRMAN FAGAN: President Leland, Ladies and Gentlemen: The closing remarks of Dr. Leland, I trust, is not intended seriously. I hope I shan't be booted this morning.

The topic for discussion this morning is the subject of public utility taxation.

We are fortunate in having as our opening speaker Professor Herbert D. Simpson, professor of public finance, Northwestern University, who will discuss the "Relation of Regulatory and Taxing Policies in the Public Utility Field."

Professor Simpson!

THE CONFLICT OF REGULATORY AND TAXING POLICIES IN THE PUBLIC UTILITY FIELD

HERBERT D. SIMPSON
Professor of Public Finance,
Northwestern University

A great deal has been said and written about the conflict between public authority and private industry. I am inclined to think that in recent years we have reached a point where there is as much conflict among governmental policies themselves as between governmental policy and private industry. Certain aspects of regulatory and taxing policies in the railroad and public utility field represent one such area of conflict. My comments this morning will be directed toward three particular aspects of this problem, namely:

1st. The Treatment of Valuation by Regulatory and Taxing Authorities.
2nd. The Treatment of Taxes by Regulatory Authorities.
3rd. The Treatment of Regulation by Taxing Authorities.

I. Treatment of Valuation by Regulatory and Taxing Authorities

For many years both courts and commissions labored under the confusion that value was an ascertainable fact, and that a thing could have but one value for all purposes, whatever they might be. A number of the states, for example, formerly had statutes requiring the tax commissions to base their tax valuations on those of the Interstate Commerce Commission. Mr. Justice Butler, before his elevation to the United States Supreme Court, once declared that "value is a fact," and that the same thing could have but one value, as a tub can have but one bottom. Economists have not always been as clear on this question as they might have been; and some of us were shocked when Professor Bonbright, in his comprehensive work on *valuation*, published two years ago, gave support to that view. I hasten to add that Professor Bonbright frankly amended his position in his address at Baltimore a year ago.

At the present time, I think we can say that tax students are in practical agreement that valuation for regulatory purposes and valuation for tax purposes may be two totally different things, not only because the tax and regulatory bodies may utilize different data and apply different methods of calculation, but because the two valuations in their very nature are fundamentally different things.

Rate-making valuation is a process of appraising the capital and enterprise contributed by private citizens to a public service, on which they are entitled to receive a reasonable return from the

public served. Regulatory valuation, in other words, is made for the purpose of determining an award.

Tax valuation, on the other hand, is a process of appraising the property and income drawn by private citizens from the common pile, so to speak, and enjoyed under the protection and services of the government, and in return for which the individual is under obligation to make some contribution toward the support of government. Rate-making valuation, in short, is a process of determining a *credit;* tax valuation is a process of determining a *debit*. But the credit is defined by one group of governmental agencies, on one set of general principles; the debit is defined by another group of governmental agencies, on another set of principles. And the two things are so fundamentally and essentially different that it must be considered only a coincidence if the two valuations should happen to coincide.

Now, as it happens, this is almost the verbatim statement which I had the honor to make before the Federal District Court of South Dakota in the Chicago and Northwestern Railway case in February, 1937. The decision of that court included an unusually clear approval of this general position. If the courts in general could see their way to a clear affirmation of the same position, it would go a long way toward clearing up the confusion in one area of conflict between the regulatory and taxing functions of government.

II. Treatment of Taxes by Regulatory Bodies

In the early period of regulation, taxes were assumed by common consent to represent expenses of operation, to be deducted from gross revenues in arriving at net return. And so we find the Ohio Public Utilities Commission laboriously computing the taxes paid per ton of coal hauled from Nelsonville to Toledo, other commissions computing the taxes per kilowatt hour of electric current, taxes per 1,000 feet of gas, etc. And a Maine court on one occasion actually pointed out that it might be more convenient for the commission merely to notify municipalities beforehand that if they should for any reason increase their future tax levies, such increase would be added to the utility rates.[1]

As long as taxes consisted chiefly of property and excise taxes, it made perhaps no great difference, since it was assumed that these taxes were more or less shifted to consumers in fields of private industry anyhow, and regulation merely sought to bring about the same result in the public utility field. But with the adoption of the federal income tax in 1913 and its rapid increase during the war period, the problem became entirely different.

Most of the commissions, after a brief period of wavering, settled down to the view that income and excess profits taxes were intended

[1] Re *Caribon Water, Light & Power Co.*, 117 Atl. 579.

to be actual deductions from the final net income of the taxpayer; that in private industry taxpayers could not recoup their income and excess profits taxes by charging higher prices for their products, and that regulation ought not to enable the public utilities to shift the taxes which private industry could not shift. In other words, that income and excess profits taxes should not be allowed as operating expenses, to be deducted from gross, before arriving at net income. This meant that regulatory authorities frankly took the view that their jurisdiction stopped where income taxation began.

This perfectly clear and common-sense treatment was abruptly halted when the Galveston Electric Company case came up to the supreme court in 1922. Justice Brandeis, delivering the judgment of the court, declared:

> "In calculating . . . a proper return, it is necessary to deduct . . . expenses and charges; and all taxes . . . are appropriate deductions. There is no difference in this respect between state and federal taxes or between income taxes and others." [2]

The commissions hesitated at the time to adopt such a blanket treatment of taxes and some of them actually refused to follow the Galveston ruling. But in 1923 the Georgia Railway case [3] came up to the supreme court, involving the treatment of income taxes again; and Justice Brandeis, again delivering the opinion of the court, somewhat curtly cited the Galveston decision as having settled the question. Since that time it has been the accepted principle that all taxes are to be treated as deductions from gross revenue in arriving at net return.

This means that regulation has now been extended to cover not only rates, valuations, and taxes but also to cover even the *incidence* of taxes. In other fields, economists may still struggle with the problems of incidence. But in one field, that of the railroads and public utilities, this has all been taken care of by government fiat; and we now have *regulated incidence*, so far as regulatory bodies are able to make their policies effective. This means that in judicial theory, legislative bodies have been deprived of all authority to adopt any differential taxation of public utilities, as compared with other fields of industry. There might conceivably be conditions under which legislative bodies might deem it wise to impose heavier taxes on the public utility field or, on the other hand, to grant some degree of exemption to public utility industries. Either taxing policy would be completely neutralized by a regulatory policy which would automatically pass on both excess and exemption to con-

[2] *Galveston Elect. Co.* v. *City of Galveston*, 258 U. S. 399.

[3] *Georgia Ry. & Power Co.* v. *R. R. Commission of Georgia*, 262 U. S. 624.

sumers in the form of rates so adjusted to bring the final return back to where it was before. Under this theory, public utilities became merely *conveyors* of taxes from taxing authorities to consumers.

This in turn produces some fantastic situations, for the taxes may be levied by one jurisdiction, while the resultant rates may bear on consumers in an entirely different jurisdiction. A railroad system *scoops* up taxes from the states, cities, and villages through which it runs, along one portion of its route, and spills them out along another portion of its route, according to the *relative movements of freight and taxes*—or would spill them out if regulation actually made that part of the theory effective. I will concede that the course of regulation in recent years — what Mr. Berle, in his confidential memorandum to the Monopoly Investigating Committee referred to as "the decay of the Interstate Commerce Commission"—the "decay" of the Interstate Commerce Commission has created conditions in the railroad field which defy rational analysis.

Moreover, it can be shown mathematically that where rates are adjusted on a regional basis or on conditions affecting a group of utilities, the levy of an income tax could, under the supreme court's theory of incidence, actually *increase the final net return* of some utility systems, because the rate increase necessitated by the tax would increase the income of some particular units by a greater amount than the tax they would pay.

With these and other fantastic results of this treatment of taxes we need not concern ourselves now. The fundamental fact is that under this practice regulation has been extended to a point where it can entirely nullify the deliberate intent of legislative bodies in levying taxes.

III. Treatment of Regulation by Taxing Authorities

Now, let us consider the reverse situation, when the effects of regulation come up for consideration by the taxing authority. I have in mind particularly the position of the tax commission in assessing railroad and public utility property for purposes of taxation.

Here the commission is confronted by the obvious fact that the actual value of such property has been materially affected by the results of regulatory policies over the past quarter-century, particularly in the case of the railroads. In this dilemma, the tax commission has two alternatives. It may, on the one hand, treat regulation as a fact, and assess its effects just as it assesses the effects of climate, weather, floods, movements of industry, and other uncontrollable factors that effect the value of railroad property. Or it may, on the other hand, take the position that it is not responsible for the vagaries of regulation; that taxation should not be subordinated to regulation; that if a railroad uses in its operation

valuable real estate, buildings, and materials, the function of the tax commission is to assess the commercial value of these things—so far as they have a commercial value—just as if there were no regulation, and let the regulatory authorities take responsibility for the effects of regulation on the value of the property.

Thus far, I think, the tax commissions have taken no clear position on this question. So far as their valuations are based on either earnings or market value of securities, they are adopting the first alternative. That is, they are *automatically "assessing" the results of regulation.* But in so far as the tax commission attempts to build up any so-called physical valuation or any of the various forms of reproduction cost, it is adopting the second alternative above. That is, it is ignoring the effects of regulation. I may add that so far as the tax commissions make use of elaborate "composite" averages, giving various so-called "weights" to all of these factors, including reproduction costs, earnings, and market value of securities, they are merely *evading the problem;* because in some parts of this process they are frankly assessing the effects of regulation and in other parts of the process are refusing to.

Most of us have argued in recent years for the adoption of the first alternative above. That is, for increased emphasis upon capitalization of earnings and market value of securities, on the ground that physical valuation and reproduction costs ordinarily have little relation to the actual situation of the railroads and public utilities at the present time. As a practical matter, under present conditions, any other method is likely to produce preposterous results—and I have so testified in railroad cases.

Yet we must face the fact that in so far as we base valuations on earnings and market value of securities we are definitely subordinating taxation to regulation; we are allowing regulation to take the water from the mill of the taxing authority. Regulatory policy might conceivably sometime reduce rates or impose additional costs so drastically that earnings might be zero and the market value of securities nearly so. In that case, any assessed valuation based on these factors would likewise approach extinction. The net result would be that regulation could remove billions of dollars of property from the tax rolls of state and local governments. The beneficiaries of such exemption would of course be, not the public utilities but their consumers and employees. We have perhaps not yet reached this point; but there can be no doubt that regulation has actually conferred substantial bonuses upon railroad and public utility consumers and has saddled the cost of these bonuses upon the general body of taxpayers, particularly *property taxpayers.*

Consequently, even at the risk of impairing my future value as a railroad witness, I want to put forward the thesis that on any sound principle of either regulation or taxation, the prevailing prac-

tice of both tax commissions and regulatory commissions is all wrong. I say "on any sound principle," because I am going to ask you to waive for the moment any consideration of how far it may be possible to embody the principle in actual practice. In both fields we may have got ourselves into such a muddled situation that nothing can be done about it; and consequently the analysis I am presenting may involve nothing more important than a matter of clear thinking.

But if we are going to think clearly, it would seem that the following observations are fairly obvious:

First. That the regulatory and taxing authorities represent distinct and substantially independent functions of government.

Second. That neither of these functions has been saddled with responsibility for correcting the operation of the other function.

Third. That in particular the regulatory authority was never created for the purpose of *regulating the taxing authority*, or of nullifying tax legislation, or of removing whole strata of property values from the jurisdictions of the taxing authority.

If these seemingly obvious propositions are true, it follows that regulatory authorities ought not to "monkey" with taxes at all—in any shape or form. Their function is to regulate corporate income (so far as they are concerned with income) on the basis of corporate operations, leaving government free to take as much or as little of that income afterwards as the regular legislative authorities may decide. If congress should decide to levy a prohibitive tax on certain forms of equipment, say wooden cars, in order to drive them out of use, we might feel that such a measure was either wise or unwise, but one thing is certain: the regulatory authority has no right to throw that tax into expenses (in accordance with the present judicial theory) and readjust rates accordingly, thereby both nullifying the intent of the legislation and at the same time imposing higher rates on railway patrons for the continued use of wooden cars, which it was the intent of legislation to prohibit. In other words, *regulation should stop where taxation begins.*

In concrete application, this would mean that the "reasonable return" which regulatory authorities contemplate should be the return "*before taxes*", not after taxes; and the return to capital in comparable fields of private industry, from which regulatory authorities purport to derive a concept of "reasonable" return, should likewise be income *before taxes*, not after. If this segment of income is roughly equalized between private and regulated industry, the regulatory authority will have performed its function. How much of these respective incomes may subsequently be taken in taxation is not its concern; and regulation could reduce its worries considerably if it would recognize that fact.

If it may be urged that this is impossible under present judicial ruling, I'm inclined to think it would not be impossible to secure a

different judicial philosophy. When the issue was originally presented to the supreme court in 1922 and 1923—a court never too well versed in the economics of taxation—it was unnecessarily complicated by the fact that regulatory commissions were asking for a distinction in treatment between two groups of taxes, property and miscellaneous taxes on the one hand, and income and profits taxes on the other. The court merely held that there was no ground for distinguishing between them. After criticizing and denouncing that decision for the past fifteen years, I am here today to argue for that decision: that in regulation there *is no ground* for distinguishing between these or any other taxes. The only difference is that, instead of lumping all taxes together indiscriminately and throwing them into expenses, they should all be lumped together indiscriminately and thrown *out of* expenses;—and I'm inclined to think that the courts might readily be induced to take that view.

CHAIRMAN FAGAN: The next subject for discussion at this morning's meeting is that of "Taxation or Exemption of Municipally-Owned Utilities," and the paper on this subject will be presented by Mr. Eugene E. Oakes, professor of economics, of Yale University. Mr. Oakes!

TAXATION OR EXEMPTION OF MUNICIPALLY-OWNED UTILITIES

E. E. OAKES

Professor of Economics,
Yale University

Should state and local taxes be counted among the costs of operating a municipally-owned utility, in the manner in which such items figure in the computation of the costs of private enterprises in this field?[1] This has long been recognized as an important problem of municipal finance; an answer to it is indispensable to a determination of the true "profitableness" or "subsidization" of the locally-owned utility.

One indication of the importance of this problem is the size of the investment which the municipalities have already made. *The Financial Statistics of Cities* offers a rough estimate of this type investment by cities of 100,000 population and over. The total for 1936 was 2.6 billion, of which water services accounted for 1.8 billion, and light and transit for 227 and 110 million respectively.[2]

[1] The courts seem to have accepted the inclusion within the cost of operating private plants of all taxes not excepting the levy on net incomes. See: Simpson, H. D., "Taxation of Public Service Industries," 1, *Journal Land and Public Utility Economics,* 46-48; Thompson, C. W., "Some Fundamentals of Utility Taxation," 11 *J. L. P. U. E.*, 148.

[2] *Op. cit.*, 1936, p. 169.

Since the census estimate ignores the smaller municipalities, which are particularly likely to own their own water systems, and which frequently have been forced to embark on the marketing of electricity, the statistics quoted must be regarded as a substantial understatement of the current investment in the field.[3]

Secondly, it should be noted that the volume of this type investment will probably increase in the immediate future chiefly in response to certain policies pursued by the federal government. A recent decision of the United States Supreme Court upheld the constitutionality of the receipt by municipalities of P.W.A. grants and loans made for the purpose of establishing municipally owned plants, even in the event that the utilities so acquired would compete with a private company and impair its investment.[4] This decision released $150,000,000 in grants and loans, and paved the way for additional advances of a like nature. Although it is conceded that the activity of the local units had not as yet fulfilled the expectations aroused among the advocates of municipal ownership by the appearance of the New Deal policies,[5] it seems inevitable that activity of this sort will expand. The pressure exerted by the P.W.A.,[6]

[3] The predominance of municipal ownership in the waterworks field is a matter of common knowledge, but it has often been argued that the importance of municipal ownership was declining in the provision of electricity. The basis for this claim is usually the drop in the number of municipally owned establishments from 2,581 in 1922 to 1,802 in 1932. However, it should be noted that the number of privately owned plants was cut from 3,774 to 1,627 over this same interval so that 52% of the plants were municipally owned in 1932 as compared with 40% ten years earlier. It is true that in spite of an increase in the horsepower of the equipment of municipal plants from 1,280,000 to 2,776,000 over the same interval, the installed equipment of the private plants rose somewhat more rapidly (1922; 18,570,000 to 1932; 45,191,000) so that the percentage of the total made up of municipal property dropped from 6.5% to 5.8% over the decade in question. On the other hand, the increase in kilowat-hours of current sold was almost exactly as rapid among the municipal plants as among the privately owned units, the former accounting for 4.9% of the total in both 1922 and 1932. Hence it is clear that any decline which may have been present during this decade in the activity of the local governments within the field of electric utilities, was at the most a relative one. In 1932 municipal utilities possessed a far greater horsepower, sold much more current (1922; 2,052,000 kw. hrs. to 1932; 4,328,000 kw. hrs.) and served many more customers (1922; 1,645,000 to 1932; 2,228,000) than they had been doing ten years earlier. Hence it is by no means clear that the stake which municipalities had in the electricity field was declining prior to the advent of the New Deal. [Statistics from *Census of Electrical Industries*, 1932, *Central Electrical and Power Stations*. Table 6, pp. 18-19, and p. 49.]

[4] *Alabama Power Company* v. *Ickes*, (302 U. S. 464) Jan. 3, 1938.

[5] Bauer, J., "Municipal Utilities," *Municipal Year Book*, 1938, pp. 114-5.

[6] For cases in which the P.W.A. grants appear to have been increased until voters were willing to accept them see: Doying, G. E., "How Uncle Sam Underwrites Municipal Ownership," 17, *Public Utilities Fortnightly*, 591-601.

the regional development agencies seeking a market for their power, and the rural electrification authority attempting to extend farm consumption of electricity, together with the subsidies running up to 45 per cent which the P.W.A. now offers for the acquisition of local plants are certain to produce an expansion in municipal investment in this field in the years to come. In addition it is possible that a considerable number of communities, finding it difficult to raise sufficient revenues from their property tax, will yield to the now renewed persuasions of the advocates of municipal ownership in an effort to develop a new source of income. Their prospects for actually achieving this goal are beside the point. For our purpose it is only necessary to recognize the presence of powerful forces tending to increase the volume of investment in municipal utilities and consequently to increase the importance of correct accounting practices in this field.

I have not as yet mentioned the "yardstick" plan of rate regulation. Fortunately, it is not necessary for me to embark upon an exposition of this idea or to discuss its rather obvious shortcomings. But it is necessary to recognize the fact that the "yardstick" notion is being given wide publicity. If it is to influence rate regulation, no matter how indirectly that influence is exerted, it is essential that the yardstick be a fair one, that the municipal rates with which private rates are to be compared are based upon a reasonable accounting of the costs of operation. The penalty for a failure to obtain this reasonable accounting is a necessary increase in the likelihood of an uneconomic investment of the nation's capital resources, and one of the most important considerations involved is a correct answer to the question, "Shall municipal utilities be subject to taxation?"

Let us turn first to the answers which the courts have given. In the absence of specific statutory or constitutional provisions covering this type property, the findings made have hinged on the distinction between an institution rendering a purely governmental service and one which is regarded as engaging in a business undertaking. The latter is clearly taxable by federal,[7] state[8] and sometimes by local governments.[9] The American version of the doctrine of sovereignty places the former beyond the taxing power of the federal government, and although the states have the power to tax such institutions they have not in fact chosen to exercise that power.

[7] *South Carolina* v. *U. S.* (199 U. S. 437). This case relates to the taxability of state-owned liquor stores.

[8] Pond, D. L., *A Treatise on the Law of Public Utilities*, Vol. II, Ch. 17, Sect. 400-402.

[9] Such taxability occurs when some of the assets are located in municipalities other than that of ownership. See note 16.

The logic behind the tax-free status of the property of an institution performing a purely governmental service is that the taxation of such property would be "a useless and inconsistent formality" since the government would be taxing itself "in order to pay itself money which could finally only be secured by other taxation."[10] It would in effect be "taking money from one pocket and putting it into another."[11] Moreover, it has been alleged that "the collection of such taxes might result in destroying the public character of such property."[12]

The question then becomes, "Do water, gas and electricity systems fall within the strictly governmental category?" Unfortunately the answer is not always the same. However, the bulk of the decisions seem to carry an affirmative answer[13] and the opinion of the leading treatise in the field seems to be that these institutions should not be regarded as business enterprises.[14] This is believed to follow from the general acceptance of the notion that the provision of the services in question is a public purpose, the assets of the enterprises being devoted to a public trust, and their construction or purchase being regarded as a proper subject for the levying of taxes.[15]

It must be recognized, however, that the favored position enjoyed under the property tax does not carry over to certain other forms of taxation.[16] This is the implication of the decision in *City of*

[10] *Foster* v. *Duluth*, 120 Minn. 484; 140 N. W. 129.

[11] *State of Kansas* v. *Holcomb*, 85 Kan. 178; 116 Pac. 251.

[12] *Foster* v. *Duluth*.

[13] Exceptions to this rule occur in *Louisville* v. *Commissioners* (1 Duv. 296; 85 Am. Dec. 624) and in *Clark* v. *Louisville Water Company* (90 Ky. 515; 145 S. W. 502). *Warwick Co.* v. *Newport News* (153 Va. 789; 151 S. E. 417) tends in the same direction but its value in the present connection is undermined by the fact that here the utility derived a substantial profit from sales outside the city. Similarly *Swanton* v. *Highgate* (81 Vt. 152; 69 Atl. 667) is a doubtful piece of evidence in the present connection because the utility's charter did not authorize the sale of power for private use.

[14] Pond, Sect. 406.

[15] Contrary opinions are expressed in Dawson, A. F., "A Hundred Million Dollar Tax Leak," 12*Public Utilities Fortnightly*, 756-761, and Trachsel, H. H., "When the Ratepayer Becomes the Taxpayer," 10 *P. U. F.*, 628-634.

[16] It should be noted in passing that such utilities are sometimes subject to the local property tax in so far as the assets are not located in the place of ownership. See: *Warwick* v. *Newport News*; *Swanton* v. *Highgate*; *City of Providence* v. *Hall* (142 Atl. 156). On the other hand see: *North Haven* v. *Wallingford* (111 Atl. 904-907); *West Hartford* v. *Water Commissioners* (44 Conn. 360); *Traverse City* v. *Blair* (190 Mich. 313); *Hamden* v. *New Haven* (91 Conn. 589): *New London* v. *Perkins* (87 Conn. 229); Opinion of Justices (150 Mass. 592).

In the absence of an interstate compact, property of a municipal utility which is situated in another state is clearly subject to the property tax in

Tacoma v. *State Commission* (77 Wash. 484; 34 Pac. 2nd 899) handed down in 1934. In this case a tax on the gross receipts of utilities including within its scope the receipts of municipally owned enterprises was upheld in the face of an express constitutional exemption of the property of such institutions. The logic used in arriving at this conclusion was that a tax on gross receipts is an excise and hence not controlled by an exemption which applies only to taxes on property or their legal equivalent. The effect of the Tacoma decision is to open up the possibility of taxing municipally owned enterprises even in the states where constitutional or statutory provisions and court interpretations make such taxation most unlikely. The question again becomes a matter of policy.

In order to determine the present status of these enterprises under the various state and local taxes which are now applied to public utilities, I took the liberty of directing a simple questionnaire to the tax authorities of the several states.[17] I have received replies from 39 of the 48 states, and these indicate the following facts: [17a]

(a) A property tax on municipally owned utilities exists in only one state, Indiana.[18] Although this tax has been upheld in the state courts,[19] it has a limited scope, applying only to that portion of the assets which are not used in supplying the municipality itself, and being limited to the state and county property taxes.

(b) Four states, Wyoming, Oklahoma, North Dakota and Arkansas apply their retail sales taxes to municipal plants, but the Wyoming levy exempts sales to the municipality itself, and the Oklahoma tax does not appear to include sales of water.

(c) Four states, Washington, Florida,[20] Illinois and Ken-

the jurisdiction of situs. *State of Kansas* v. *Holcomb; Kansas City, Mo.* v. *Fairfax Drainage District*, 18 *Nat. Mun. Rev.*, 710; see also, Stimson, C. W., "The Exemption of Publicly Owned Property from Taxation," 8 *University of Cincinnati Law Review*, 32-56.

[17] The questionnaire asked for opinions as to the taxability of only that portion of the assets located within the place of ownership.

[17a] Subsequent to delivering his paper Professor Oakes submitted the following in reply to his questionnaire: Louisiana applies the state property tax to publicly owned utilities and apparently permits parishes to do so if they desire, and the Colorado retail sales tax applies to sales of such utilities.

[18] 1933 Acts, ch. 190, sect. 16d.

[19] *De Haven* v. *City of South Bend*, No. 26700, Supreme Court of Indiana, 1937.

[20] Florida was not one of the states replying to the questionnaire. However, a compilation of laws issued in 1934 indicates the existence of a gross receipts tax on "corporations, etc., receiving payment for electricity, gas, use of telephones etc., "which applies to municipal enterprises in these fields." Ch. 15658, Acts 1931, Sec. 1, Extra Session.

tucky,[21] apply their taxes on the gross receipts of utilities to municipal plants. However, the Florida and Illinois levies do not include water sales, and the Kentucky tax appears to exempt sales made to the municipality itself.

(d) One state, Vermont, has a state tax of five-tenths of one mill upon each kilowatt hour of electricity manufactured within the state and this applies to a municipal electric plant as well as to the private enterprises in the field.

(e) Finally, it should be noted that although Wisconsin and Ohio exempt municipal plants from all taxation, it appears that Wisconsin requires such plants to carry on their books a charge equal to the amount of the local and the school tax which would have been levied on taxable property, while Ohio has a similar and apparently broader bookkeeping requirement. It is safe to conclude from this evidence that there has been relatively little attempt to collect taxes from municipally owned enterprises.

Let us turn now to the arguments commonly advanced in favor of the exemption policy. There is, first, the legalistic point already mentioned that a locality taxing its own enterprises is in reality taxing itself, while a state taxing municipal utilities within its borders is guilty of the same procedure since the municipality is simply an extension of the sovereign power of the state.[22] These arguments are closely associated with the notion that a government taxing its own enterprises is simply transferring money from one pocket to another,[23] and consequently it is inferred that such taxation is a futile and unjustifiable proceeding.

The only portion of this logic which warrants serious consideration is the "robbing of Peter to pay Paul" argument which embodies the implicit assumption that the incidence of the rates is identical with the incidence of the substitute taxes that would be called into action if the revenue from the rates were altered. More specifically, in order to accept the above argument as conclusive it would be necessary to assert, first, that approximately all of the people who bear the final brunt of the property tax are also consumers of the utility's services, and, secondly, that their consumption of those services is an accurate index of the burden which

[21] The Pennsylvania gross receipts tax on electricity applies only to such receipts as are derived from business done outside the limits of the municipality operating the utility service.

[22] Cooksey, T. L., "Why Municipal Utility Plants Should Not be Taxed," 15 *P. U. F.*, 183-188. "A municipality is an administrative subdivision of the state and just why a state should ever tax itself or any part of itself has never been made entirely clear by the advocates of the municipal plant tax" (p. 185).

[23] *Foster* v. *Duluth*.

taxation would put upon them. In the majority of cases the rate-payers and the taxpayers are not identical groups; in many cases a substantial difference exists; and it is probably also true, although conclusive proof is lacking, that the rates paid are by no means an acceptable index of the relative burdens which a local property tax would impose.[24] Consequently, the conclusion seems inescapable that only under the most unusual circumstances can the tax levied upon a municipal utility be accurately described as a simple process of "transferring money from one pocket to another."

A second line of argument attempts to justify exemption on the basis of the public purpose which supposedly dominates the local utility. Sometimes an analogy is drawn between these plants and charitable, religious or educational institutions, the source of the analogy being the non-profit making character of the enterprises in question.[25] Sometimes a comparison is drawn between a municipal utility and a public highway. Both are supposed to be dominated by a public purpose; both supply services to private individuals on an extensive scale. Why, then, exempt the highway and tax the utility?[26]

The first of these two analogies accomplishes too much. It raises the question of the propriety of the exemption of the charitable, religious and educational institutions and the validity of these exemptions is entirely too controversial a basis upon which to build an attack upon the policy of taxing municipal utilities.[27]

In the case of the second of the two analogies, it appears fairly obvious that although both highways and utilities yield general benefits as well as particular services to individual consumers, the benefits accruing to the community as a whole are in one case larger and more difficult to evaluate. The absence of a technique of measurement may justify the crude offsetting of the general benefits received by the community and such items as interest and

[24] Some evidence on this point was offered by H. K. Hyde in his "Municipal Utility Profits on Taxes?" 12 *J. L. P. U. E.*, 212-215.

[25] Cooksey, *op. cit.*, p. 184-5.

[26] Ibid., p. 186. It is interesting to note that the second of these two arguments appears basic to the policy advocated by the first chairman of the Wisconsin public utility commission in the regulation of the rates of municipal utilities, as well as the policy which the New York commission failed to establish in the Boonville case. However, it should be pointed out that in both these instances the argument was advanced in connection with the inclusion of a charge on the investment of the municipality rather than a tax in the common meaning of the word. See: Riley, R. H., "Municipal Utility Regulation in Wisconsin," 22 *P. U. F.*, 300-309, and *Customers of Electricity* v. *Boonville*, 5 *P. U. R.* (N. S.), 298; 8 *P. U. R.* (N. S.), 493.

The argument is used in the present connection by Cooksey.

[27] Knapp, F., "Tax Exemptions," 1934 *Proceedings of the National Tax Association*, 74-84.

taxes on the investment in the highway right of way. But not so in the case of the utility, for here it is possible to assign a price to most of the benefits received by the community, and to all but the most general of the services which the utility receives from the community itself. Hence one is led to the conclusion that the analogy drawn between the highways and the utilities is also inconclusive because it fails to recognize a significant difference of degree.

A third approach to the exemption policy accepts the idea that exemption is a concession to the local enterprise but argues that the concession is more than offset by certain other factors. The crudest manifestation of this approach may be illustrated by an argument advanced many years ago by Professor Commons.[28] He apparently believed at the time that the loss of the taxes which would have been paid by a private utility would be more than offset by the increase in property valuations following the extension of services under the municipal régime. This of course leaves the cost of such extensions entirely out of account. In addition it was argued by Professor Commons that even though the removal of the utility from the tax rolls by the fact of municipal ownership meant an increase in the burden of taxation put upon the other property owners in the municipality, this would be compensated for by the relatively low rates which municipal ownership would produce. The validity of this point depends again upon the complete identity of the ratepayer and the taxpayer and, as has been indicated, this is a very dangerous assumption.

A more sophisticated version of this approach to the problem consists of the argument that the contributions which the plants make to the municipality in the form of services rendered free of charge far exceed the value of the exemption privilege.[29] Now it cannot be denied that such services rendered to the municipality are a proper offset against taxes due. However, it must be recognized that the exact equivalence of these offsetting charges would be so unusual as to be accidental, while a lack of equality in the items offset produces either a concealed subsidy to the utility or a concealed bonus to the general treasury. The fact of concealment is in itself a major evil. Consequently, I must agree with those who have repeatedly asserted that correct accounting requires the

[28] Commons, J. R., "Municipal Electric Lighting," in Bemis, E. W., *Municipal Monopolies,* (1889) pp. 104-5.

[29] Bartlett, L., "Tax Free Cities," 23 *National Municipal Review,* 614. Here it is asserted that the contributions made in California are nearly three times the size of the taxes which would have been paid.

The reverse result was obtained in a study made by Professor Borak (13, *J. L. P. U. E.*, 116-129) relating to the utilities of certain cities in Minnesota. Here the conclusion was drawn that with a few exceptions the services rendered were not the equivalent of the exemption privilege.

collection from the utility of fees for services rendered to it, plus a tax in return for the more general benefits which the institution enjoys, and the granting of a credit for the specific services which the utility renders to the community in general. This procedure is distinctly preferable to the crude offset of taxes and services which is the result of the exemption policy; it would assist materially in an understanding of the operating record of a municipal enterprise.[30]

Fourthly, there are the arguments which accept the subsidy involved in exemption as a means to a desirable end. It is said, for instance, that the great social utility of the commodities supplied by the municipal enterprises, together with the alleged elasticity of the domestic demand for them, justifies a subsidy. In this way low rates will be produced which will lead to more extensive consumption of the service rendered. It is also possible to argue that the burden of the rates is more regressive than that of the property tax which usually would be called upon to finance a deficit, and that therefore the substitution of the tax for the rates through the exemption of the utility might be justified on the grounds of economic or social welfare. The validity of the latter argument depends upon the unsettled and extremely difficult question of the relative degrees of regression involved in the rates and the property taxes.[31] However, it is not necessary for us to enter upon this problem or upon the question of the social policy involved in either of the above arguments. We need simply repeat again that the concealment of the size of a subsidy through the use of the tax exemption device is in itself an evil sufficiently important to require more elaborate accounting procedures.

Finally, there is the argument that the low rates which exemption is expected to produce are justifiable as an incentive to the increased efficiency of the private utilities.[32] The familiarity of this attitude does not prevent its rejection. It is, to put it bluntly, the yardstick idea in its objectionable form, a simple proposal to belabor an industry with unfair competition.

[30] For expressions of this opinion see: Jensen, J. P., "Public Revenue Sources Supplemental to Taxes," *Proceedings of the N. T. A.*, 1927, pp. 82-98; Trachsel, H. H., "When the Ratepayer Becomes the Taxpayer," 10 *P. U. F.*, 628-634; Wilcox, D. F., *The Administration of Municipally Owned Utilities*, pp. 61-62.

[31] Hyde, *op. cit.*

[32] "In view of the tremendous importance of electrical energy in our urban civilization, voters and taxpayers might better keep their municipal establishments tax exempt; eschewing all attempts to have them make a 'profit' and striving to secure the lowest possible rates and the highest possible utilization. Private ownership will then have a real incentive to lower its costs to a competitive level." Smith, W. L., "The Municipally Owned Utility; Profit or Service?", 23 *National Municipal Review*, 620.

In dealing with these arguments for the exemption policy, we have made certain assumptions which need to be stated and subjected to close scrutiny. First, we have assumed that the incidence of the rates is on the consumer, that an increase in these costs of production will be reflected in the price of the service rendered. Now there are cases in which an increase in taxes may not cause a rise in price, for instance, when the utility is already earning more than a fair return, or when public relations are so unfriendly that they prevent the normal processes of rate regulation.[33] Again, in the absence of proper regulation it may be true that a reduction in costs will not produce lower rates, but the reasonable procedure for our purpose is to assume adequate regulation and this leads to the conclusion that the incidence of the state or local taxes applied to utilities, whether they be taxes on property, gross receipts or even on net income, will probably fall on the ultimate consumer. In the case of retail sales this means the purchaser of the electricity, gas or water supplied. In the case of sales to manufacturing enterprises, it frequently must mean the consumers of the goods or services produced. Hence, in those cases where substantial sales are made to enterprises selling goods outside the taxing jurisdiction[34] there remains little basis for the exemption policy. The latter would lead to the subsidization of non-residents at the expense of the local taxpayer. In the cases where such sales do not constitute a major consideration, the chief result of the exemption must be an automatic, unplanned and frequently erratic redistribution of the burden of taxation.

Secondly, we have assumed that the exemption of a municipal plant is a matter of concern only to the taxpayers of the jurisdiction in question. When state or county property taxes exist, and when privately owned property remains subject to them, this proposition no longer holds. Exemption eliminates the utility property from the tax base and produces a redistribution of the state and county taxes in favor of those jurisdictions operating exempt utilities. A somewhat heavier burden in other jurisdictions is a necessary result.[35] So far as the county and state levies have declined in importance the strength of this argument appears at first glance

[33] C. W. Thompson cites the case of a New York utility whose request for higher rates based on higher taxes was checked by a threat to construct a competing municipal plant. This occurred in 1934. (11 *J. L. P. U. E.*, 148-149.)

We wish to object to this author's argument that prices will not rise with an increase in costs if the utility is getting full monopoly price. A change in costs alters the point of maximum monopoly profit. If the utility is free to seek the latter its rates will rise. If it is not, the case becomes of little importance.

[34] This situation is known to exist in certain towns in northern Vermont.

[35] Trachsel, H. H., "How the Tax Free Utilities Hurt the Farmer," 15, *P. U. F.*, 472-477.

to have been reduced. However, if the exemption policy has been carried over to other forms of state taxation, and this is the usual case, a similar shift in the burden of state taxation will necessarily follow. Consumers of the exempt utilities are favored at the expense of the persons bearing the burden of that tax which serves as a balancing item in the state budget. If this happens to be the property tax, the same results are obtained as in the case where the property tax is the major item in state and county finance. In any event the exemption policy effects a redistribution in the tax burden outside as well as within the municipality owning the exempt plant. This redistribution would be impossible to justify and its existence constitutes an additional argument against the exemption policy.

Finally, we have assumed in our argument that a municipal utility is just as much the recipient of the benefits of government as its privately owned counterpart, and that in both cases the receipt of these benefits provides the logical basis for taxation. If this proposition is coupled with the policy of reimbursing the utility for services rendered to the community, there can be little rational basis for an objection to it. Its acceptance would complete the case against the exemption policy.

However, the last of these three assumptions brings to mind another point which I would like to make in closing. Granting that the benefits of government are a sufficient basis for taxation, can the benefits received by this type property be used in answering the further question, "By whom shall the municipal utility be taxed?" This point is raised by the frequent recognition of the fact that this type property imposes very few burdens upon the locality in which it is situated. It adds but negligible amounts to those highway expenditures which are financed out of the general revenues of the local government; it employs relatively few people and hence its presence does not add very much to the cost of schools; it furnishes stable employment and consequently will not be responsible for additional relief expenditures when times are bad. In fact the benefits of government which appear most relevant in this case are the privilege of the franchise received from the locality where the sales are made, and the general privilege of operating in a peaceable environment which is primarily the product of the system of law erected and enforced by the state. It seems to follow from this that a local property tax on these utilities will produce inequitable results when the physical property is not located in the same place where the sales are made, and equally bad results will follow when state assessed and collected taxes are distributed to the localities according to a formula which gives substantial weight to the physical situs of the property. Moreover, we have had a number of studies revealing the tremendous bonus received under such arrangements by localities in which large electric generating stations serving other communities are located. In many of these instances

overly-plentiful revenues have produced extravagance, in some cases the pauperization of a town, in some real corruption in the political system.[36]

It seems to follow that the locality of physical situs has little claim to the tax on utilities, whether municipal or private. This tax ought to be handled by the state, and, in order to include the municipal enterprises within its scope, ought to be constructed in the gross receipts form. The state itself has a substantial claim to a share in the proceeds of such a tax but the bulk of the revenues ought to be allocated to the localities in accordance with the gross receipts criterion, thus bringing the bulk of the revenues to the community which confers the primary benefit, the privilege of the franchise.

Under such a system of taxation the question of the exemption of a municipally owned utility would be thrown into its proper light. Exemption would be clearly recognized as a matter of subsidizing the consumers of a particular set of commodities out of general tax revenues since the granting of such a subsidy would require the actual voting of funds by the municipality in support of its utility enterprises. It is only under circumstances such as these that the nature of the choice before the electorate is obvious enough to produce a real weighing in the balance of the alleged social justification of a subsidy of this character.

CHAIRMAN FAGAN: As the concluding subject in this forum this morning, we have a home-town subject and a home-town boy. It is my pleasure to present Dr. Lent D. Upson, director, Detroit Bureau of Governmental Research, who will discuss "The Financial Problems of the Detroit Street Railway."

LENT D. UPSON (Michigan): I am a little surprised that a discussion of the finances of the department of street railways should be injected into a program attended by a group of persons interested primarily in taxation. It is either an evidence of unusual interest in probably the largest experiment in municipal ownership of transportation systems in the country, or there is an implication that the municipal street railway system is a blonde jade, the keys of whose apartment are in the pockets of every politician in the City Hall. (Laughter)

36 Groves, H. M., and Keith, G. M., "Some Solved and Unsolved Problems of Public Utility Taxation in Wisconsin," 10, *J. L. P. U. E.*, 109-119; Cline, D. C., "Object Lesson in Tax Sharing: The Distribution of Public Utility Tax Revenues to Municipalities in New Jersey," 14, *J. L. P. U. E.*, pp. 284-300; Oakes, E. E., *Studies in Massachusetts Town Finance*, ch. VII; and "The Taxation of Public Utility Property in Vermont," *Bulletin of the N. T. A.*, Dec. 1935.

I hold no particular brief for the gal, certainly would not in communities less well governed than the city of Detroit, but with us she has been pretty well behaved, works hard, turns her earnings over to the parents, and we have no particular complaint to make about her.

To understand the financial problems of the D.S.R., if the D.S.R. has any very serious financial problem, one has to look for just a moment at the background of its acquisition by the city, because I think the conditions under which the city secured the old Detroit United Railways have had a good deal to do with the elimination of the financial questions that might have attended a plant acquired at fictitious values and under other circumstances. The Detroit United Railways was a union of various isolated privately owned railroad lines which grew to greatness during the period when car-riding was at its peak. The company paid 8 per cent on its capital stock for many years, boasted of that fact, advertised that it was plowing in its surplus earnings for the benefit of the public that it served.

You are not concerned primarily with the controversy in detail which led to the acquisition of the plant by the city of Detroit. It is enough to say that it was the result of long years of quarreling between city officials and the operators of the system. There were charges of stock gambling; it was a very simple thing to promote in those times. All you had to do was to get into a first-class row with the city of Detroit and the stock went down, then settle your differences and the stock went up. I know nothing about the merits of those charges. Suffice it to say that the D.U.R. operated under a miscellaneous set of franchises, expiring at odd intervals, which provided on the whole that taxes should be paid under our constitution upon the fair cash value of the property in a market in which the seller is not compelled to sell and the buyer is not compelled to buy, a very simple formula which all of you have solved in your business; that they should charge a five-cent fare on most lines and should charge a three-cent fare on others, that they should pave between the tracks, which I assume was a relic of the horse-drawn vehicle, but they should not pave between the tracks when they charge three cents for their fare.

The culmination of the fight came about with the very rapid growth of Detroit between the years 1915 and 1925, when the D.U.R. found it impossible in the face of rising prices and stationary car fares to give us the extensions that were necessary in a community that was increasing both in area and in population. It was obviously impossible to finance extensions without extensions of franchises, which the public was unwilling to give.

Under these circumstances, the late James Couzens, then mayor, who was a two-fisted sort of an individual, took action. I recall

once when the city assessors told him they had no means of finding out how to assess the personal property in Detroit, he threw the telephone book across the room and said, "Put everybody on the list that has a main line telephone." He was a direct-actionist sort of a fellow.

He first entered into arrangements with the D.U.R. for the building of extensions at their expense, with the proviso that they might be taken over by the city at any time at the cost, new, less depreciation, which gave the city the right to acquire a considerable trackage in the outskirts of the city. At about the same time, a bond issue of $13,000,000 was issued which was designed to build a competitive system. This had grown out of the fact that the city had been unable to agree with the D.U.R. as to price, so the city found itself then in a position of acquiring and building and leasing from the D.U.R. a sort of an independent street railway system which was to run parallel or supplementary to the D.U.R. system.

At about that point, the franchise on Woodward Avenue, which is in front of this hotel, expired, and in the face of the D.U.R.'s willingness to sell at Mr. Couzens' price, he told them to rip up their tracks and get out of the street and the city of Detroit would get along very well without the main line of transportation north and south in the city. Allegedly he had some street car rails in hand that he was going to lay on some side street and was going to run a system in competition with the main-stem root.

It is needless to say that the method of acquiring the D.U.R. contained a number of dynamic situations which perhaps had something to do with the eventual price which the D.U.R. got for their properties, which was $19,000,000, $2,000,000 of it in cash and the rest whenever they caught up with the city.

In view of the fact that the court allowed — I believe it was Denver—$23,000,000 for a transportation system for a city of some 250,000 population at the time, it is not unreasonable to believe that the city did not overpay when it bought the hundreds of miles of system and cars in this city for a total of $19,000,000, which was adding to the $13,000,000 it had already invested in a system of its own, which was not a duplication in any way of the older system.

For anyone to say that they got a property in perfect condition would be anything but correct. The engineers, both of the D.U.R. and of the department of street railways, said that its operating condition was about 70 to 75 per cent of normal. At any rate, there were statements made that the city would never be able to run cars on the tracks after they got them. The D.U.R. had obviously let the plant go to pieces when they saw they were going to be dragooned or bludgeoned into selling to the city.

We had some figures at the time which may or may not be pertinent to the issue. As to breakages, for example, in one month there were 297 breakages in overhead lines, which is about ten a day,

and for five months immediately preceding the purchase of the plant, there had been breakages at the rate of 200 a month, and you can imagine what breaking 200 power lines would do to a street railway system operating in a big city. Very shortly, however, the city reduced that to less than 80 a month. Immediately upon the acquisition of the system, it was obviously necessary for this community to put a considerable amount of money into a rehabilitation of the plant, and later into extension of the plant. To the initial cost of $36,000,000 which was for the city's own plant and the new plant, there was added $17,000,000 for additions, making the total purchase price a little over $50,000,000 for the system you see operating here. There is today still outstanding on the debt, still outstanding of funded debt, about $28,000,000 and some small items of short-term paper which are of no particular consideration. In consequence of that, it might be said that the liability in this particular situation is considerably less than would be found in many other public or privately owned plants in the United States. I jotted down some figures as to the fixed assets, which would include, of course, both liabilities and the surplus that has accumulated through earnings, and find that in Boston for each 1,000 revenue passengers there is an investment of $371, in Washington $345, in Toronto $310, in Detroit $237, which is an indication that the plant does not have to earn on any excessive amount of assets.

So we have built up a plant worth some $50,000,000, probably, less some depreciation, with a debt outstanding of, let us say, $28,000,000 or $30,000,000, which is serving a community of 1,800,000-odd population, with an over-all mileage of 450-odd miles, and with more than 500 miles of bus routes.

Now then, what are the financial problems which the D. S. R. faces immediately out of this situation? First, is the general cost of operation in this city. Second, the reduction in car-riders, which is being felt by every transportation system, whether it is municipally owned or not, and third, is this question of obsolescence which must be plaguing every transportation manager in the United States.

As to the cost of operation, it is questionable whether our costs are excessive as compared with other communities. I would doubt that they are. We pay a total of about 54 cents out of every revenue dollar for payroll, and we pay the highest rate of pay in the United States, 83 cents per hour for one-man cars and buses, as compared with 80 cents in Chicago, 67 cents in Milwaukee, 78 in Boston, 69 in St. Louis, 61 in Los Angeles, 70 cents in Philadelphia.

The unions are demanding a dollar an hour, which request was declined, and how soon we will pay a dollar an hour nobody knows, not under the present situation, at least.

There have been some union squabbles, but I doubt that they are any more serious than those that are taking place in other

communities. Our rows have been strikes not against the city in particular but between one union against the other within the department.

You know, out here in this country we have what we call the initiative and referendum, which Theodore Roosevelt said was a shotgun behind the door. Well, it isn't behind the door out here, it is right out in the parlor, and we use it repeatedly. We have had about three amendments now initiated by different unions within the D.S.R., one giving seniority to the busmen. The town passed that. The next election we had an amendment rescinding that and putting them under general seniority, and the town passed that. Then the busmen initiated one of their own, the last one had a five-cent fare tagged to it. It was defeated nine to one, which shows that the public does think about things when they are put to it.

The D.S.R. pays some small amount for maintenance between the tracks, which they would like to avoid. They have repeatedly asked the city to permit an avoidance of that charge, holding that in an automobile community there is no particular reason why they should be penalized by paving a certain portion of the street. The city has never seen fit to grant that immunity, and they are still paying that charge. Apropos of the last speaker's discussion, the D.S.R. is compelled to operate as a private industry, and pays taxes. The plant, which you may or may not say, has a valuation of around $50,000,000, is assessed, I believe, at some $18,000,000, and pays something under $800,000 in taxes to the city of Detroit, Wayne County, the city of Highland Park, and Hamtramck, which are served by the utility.

This is perhaps less taxes than might be exacted from a privately-owned corporation. It is more taxes than most utilities publicly owned are paying into the public treasury.

The matter of operation in Detroit is further complicated by the rate of fare. Detroit gives you a ticket for six cents, or a ride for six cents, with one cent extra for a transfer. If you ride on the buses, that is ten cents, with a free transfer, although there are sixteen bus lines that can be ridden on for six cents, and after certain hours of the day the buses supersede the street railways on many lines.

Let me show you a comparison, however, of street railway fares. That of Cleveland is ten cents or six for fifty; Philadelphia, eight or two for fifteen; St. Louis, ten cents or four for 35 cents; Baltimore, ten cents; Boston, ten cents; Chicago, seven cents, or three for 20 cents. The D.S.R. authorities state that if Detroit had operated its street railways at a rate of fare which was the average of the rates prevailing in other large cities, they would, during this period of municipal ownership, have earned, in addition to their present earnings, $56,000,000, which is more than the value of the plant.

The second problem of financing deals with the changing of riding habits, a phenomenon which prevails in every community. It probably arises from the recourse to the automobile in these modern days. It is particularly pertinent in the city of Detroit, which has a highly fluctuating population. We are essentially an industrial community. We do not enjoy the hinterland which is enjoyed by many large cities in the United States. We end on the north with Bay City and on the west with Kalamazoo, and on the south with Monroe, which is this side of Toledo, and on the east with a handful of customs and immigration inspectors at the river's edge.

We have no great economic area to draw from. Our economic life being essentially industrial, you can trace and measure the industrial activity of the city day by day by the number of fares that are collected by the D.S.R. Not only is the use of the transportation system declining, but it is further, as I say, subject to these rapid fluctuations.

Let me cite you an example. In 1929, which was the peak year of prosperity and of car riding, the D.S.R. carried $22,000,000 of revenue passengers and moved 50,000,000 revenue miles. From $22,000,000 we dropped to less than $10,000,000 during 1933, and the number of revenue miles was cut substantially in two. Now, that is a tremendous burden for a street railway system to bear. Now we are up to $14,000,000, representing 33,000,000 miles of traffic.

The city has endeavored to meet that situation by substitution of buses, as I say, in the evening, and a reduction of expenses in every possible direction, and has been sufficiently farsighted to at least think of municipal transportation in the form of a taxi service. The assistant to the manager told me yesterday, "We look forward to coming just as close to furnishing taxi service to the people of Detroit as possible in an effort to recapture their car-riding habits." The third item which is involved is that of obsolescence. My old friend Davis F. Wilcox once said in one of his books, "Changes in the arts due to the versatility of human mind and in the face of need, municipal requirements maturing as the political and civic exigencies of the community mature, the over-mastering influence of economic revolution, the shifting status of population in industry, all of these are concealed behind the drawn curtains of the future and with them are hidden waste and times of obsolescence."

During this period, during the last ten years, there has been a tremendous increase in the number of buses used by our system. In the main, after an experiment with the very large and heavy buses, they have been supplanted by light and inexpensive buses run by a single operator, giving speedier service and more frequent service. The mechanical critics, technicians, say that the bus will never supplant the street car as a means of mass transportation.

I know nothing about that except that the technicians have been wrong so many times on so many things that one may suspect that perhaps they are going to be wrong in this instance. If the D.S.R. is compelled to move very rapidly over to buses it will obviously mean the scrapping of a plant outstanding against which is some $28,000,000 of long-term securities. Up to this time, the city has had no difficulty in meeting the interest and debt service charges against that debt. Last year, which was a year of depression in Detroit, they missed by the sum of $45,000. The maximum charge that we face in any year for debt service is a little over $3,000,000, which reaches a peak in 1942. From then on, the debt service goes down rapidly until it becomes a cost of no particular moment.

It is not to be assumed that given any break in the number of car riders, the city will have any difficulty in the next six years in meeting those debt charges. With that, one sees no particular difficulties ahead of the D.S.R. financially.

There is one question which every student of the department of street railways asks after he asks whether we pay taxes or not, and that is what we do about depreciation. The D. S. R. has never charged depreciation against its plant, and that is why the values are perhaps, as I have stated, somewhat fictitious. They have, on the other hand, set aside debt service in lieu of depreciation, saying that that charge was always higher than an ordinary depreciation charge would have been.

Why the D.S.R. authorities have skirted so vigorously around the question of depreciation has always been a puzzle to me. If you raise the matter with them they talk about a double charge, one being for depreciation and the other being for debt service, and make the statement that no public utility commission would ever countenance any such charges on a private corporation. I have never yet seen anyone who was able to explain to them that no such thing as a double charge was involved, but that, on the other hand, the operating expenses of a plant could not be accurately reflected unless depreciation was included as an operating charge. When you go on to say that charge for debt service is properly a charge against depreciation reserves and against surplus, and doesn't involve a double charge, why, then, " Well, let us leave the thing alone, it is going all right." That is the same problem we have, Mr. Oakes, with our department of water supply. If we started to charge them taxes, they will start to charge us for the use of the fire hydrants and the free water we give the city schools and the churches, and why not leave it alone and let it go just as it is. There is no big problem involved, according to the general administrator, and thus long-haired reformers and theoretical technicians are faced with a fact and not a theory.

CHAIRMAN FAGAN: We have now reached the part of the program in which we have general discussion from the floor. I trust that we will keep the peace reasonably, limit the discussions to the seven-minute limit, and I am sure out of the discussions we will derive a good deal of benefit. Professor Fairchild has not arrived as yet, and we will therefore proceed with the discussion from anyone who wishes to discuss. Will you please give the stenographer your name and state?

PHILIP ZOERCHER (Indiana): Professor Oakes referred to Indiana as being the only state in the union that is taxing municipally owned plants. Well, Indiana was the leader in other respects. Indiana was the first state in the union that had a state tax commission. I think Indiana led in the way of controlling public expenditure. Indiana is not attempting to tax that part of a municipally owned plant used for municipal purposes. It is only attempting to tax that part of the plant that is used for commercial purposes. The gentlemen said it is still in court. Well, the supreme court of the state of Indiana held the law constitutional, a petition was filed, an appeal taken to the supreme court of the United States, and the supreme court of the United States says there is no federal question involved. I wrote the gentleman a letter. Maybe I didn't explain it plainly enough. (Laughter) If the gentleman knew what is back of the suit that is filed in Allen County at Fort Wayne, he would know that every point that they are raising in that question was decided in the other case, and even if there had been no special law passed by the 1933 legislature, providing for taxing that part of the municipally-owned plant used for commercial purposes, the plants could have been taxed under section 6 of the law, because section 6 of the law follows section 5. Section 5 is the law that sets out all tax-exempt properties. Then section 6 says, "If all or any part, parcel or portion of the foregoing is used for other purposes than for which it is tax exempt, that part, parcel or portion shall be subject to taxation."

That part, parcel or portion that is not used for municipal purposes shall be subject to taxation. In the state of Indiana we have the municipal league, and I say it is not to the credit of a municipal league, composed of municipal officers, to violate or disregard a law passed by the legislature, the constitutionality of which was upheld by the supreme court of the state of Indiana, and then one that the supreme court of the United States refused to consider because it said there was no federal question involved.

The Indiana Supreme Court in 1891 said this, "When a municipal corporation engages in an activity of a business nature rather than one of a governmental nature, such as the supply of light or water or the operation of a railroad, which is generally engaged in by individual or profit corporations, it acts as such corporation, and

not in its sovereign capacity, and a city operating its municipally-owned utility plants in its proprietary capacity as a private enterprise is subject to the same limitations and regulations as any other public utility." Following that, the legislature then in 1933 passed a law that the municipally-owned utilities shall pay state and county taxes. That was a concession to those utilities in itself. In fact, they could have gone further and said for all purposes, like any other property. I contend that if the other states haven't done that, they ought to do it.

We have in the city of Minneapolis the water and light company; the total assessment is over $50,000,000. What does that mean? If you take that $50,000,000 off, all the farmers in Marion County would have to pay that much more county tax, and that much more state tax. In the interest of propriety, if you take that $50,000,000 off, why, we know that everybody else would have to pay more taxes.

I honor the man from the city of Evansville, who is on the water board, who was judge of the superior court there. When the cases were pending he told the mayor he was of the opposite political party of the mayor and the city administration, but he said, "Mr. Mayor, don't pay any attention to this municipal league argument, because under our constitution, that part of our water plant that is used for commercial purposes should pay taxes." That was before the supreme court had passed on it. Then later on, of course, he felt satisfied that he had broadened the point of view to see that that was paid.

I don't want to fall out with Professor Oakes here, but if he didn't read all of the citations here of the supreme court—I gave citations here of the supreme court of the United States in reference to the question of taxation—I think he ought to read them.

C. M. Chapman (Wisconsin): Whoever answered the questionnaire of Professor Oakes from Wisconsin apparently wasn't very familiar with the situation up there. In order to explain the situation so far as the taxation of municipally-owned property is concerned in Wisconsin, it is necessary to go back several years to a law that was on our statute books, which provided that if municipally-owned property was outside the municipality and was used to serve the municipality for profit, it should be taxed. That was a vicious law, for if you lived outside a municipality and wanted service, they wouldn't give it to you unless they could do it and keep the taxing authorities from knowing it. Because as soon as it was found out that they were serving you, unless they could prove it wasn't for a loss, they were subject to taxation.

In 1925 that law was repealed. The present law states that any municipally-owned electric utility, serving outside its own boun-

daries, is subject to taxation and is taxed like any other utility, at the average rate of taxation.

At the time that law was passed there was considerable opposition from the municipally-owned water utilities, who, in several instances, had a water tower just outside the boundaries of the owning municipality, and they raised a terrific howl. Well, those who were interested in correcting the other situation looked upon the water utility as so closely akin to the general health policy of the state that they said, "Exempt the water utility from taxation." So it is at the present time.

So far as a municipally-owned property within the limits of the owning municipality is concerned, a good many years ago there was a conference between what was then known as the railroad commission, now public service commission, and some members of the tax commission—I don't know who they were—on this question of taxation. The feeling of the regulatory body was that the municipality should pay some form of tax, which at least should put it into their operating expense—it might be a book transfer from the utility operating accounts to the municipal accounts, or they might actually pay that tax from the municipal utility to the municipal treasury. Either way would serve the purpose. It was agreed in that conference—and more or less that same situation still prevails—that the municipal utility should be assessed annually by the local people at a figure representing somewhere near a cost less depreciation, and the rate to be applied would be the local and school rate. In most of our municipal communities where municipal ownership prevails, that is the situation.

There is a movement right now in the state of Wisconsin urging a general taxation of municipally-owned utilities along the lines Professor Oakes spoke of. I just saw a comment the other day in one of our papers. I rather think that would come to pass in a very short time were it not for the fact that 15 per cent of the taxes, utility taxes, revert to the state treasury. The league of municipalities doesn't like that. If that were lessened, as the league of municipalities wants it to be, that all utility taxes shall go back to the community excepting for the cost of collection—and that is the sentiment among the league of municipalities—then I think in Wisconsin very shortly we will have a rather uniform taxation of utilities privately owned and municipally owned.

Along the line of the talk of Professor Simpson, we have commenced to sense in Wisconsin a sort of a feeling in our regulatory body that we are somewhat adverse to the tax commission in its assessment of public utilities. Only last week I received a copy of an office memorandum comparing the taxes on privately-owned utilities in Wisconsin with those in other states, based on a proportion of gross revenue, and they tell me that unless the tax commis-

sion as a taxing agency eases up on the utilities, why, they are sort of restrained in their regulatory desires to cut the rate and pass on the benefit to the consuming public. As far as the public service commission is concerned, we are almost treated as a general enemy, although we are friendly.

I was also rather astounded when a few weeks ago one of the members of the staff, rather prominent in the public service commission, made the statement that they did everything else so far as public utilities were concerned, they could see no reason why they shouldn't be handling the tax question too, and make it unanimous.

MR. OAKES: I would like to answer one point which the previous speaker raised in his remarks. In my questionnaire I specifically asked for replies only with respect to that portion of the property which was included within the municipality of ownership. Nevertheless, the gentleman from Wisconsin who answered my question gave me all the details which have just been presented to you. I did not wish to go into the further question which was involved in the taxation of property outside the jurisdiction of the municipality ownership, although I recognize and had indicated a footnote that that sort of taxation frequently exists. I think that will clear up the misapprehension that might be present.

MARTIN SAXE (New York): I would like to get a little more light from Professor Oakes. You weren't so very illuminating. Take, for instance, the TVA situation, and conceive the extension of that idea to another state. I understand the TVA voluntarily pays taxes in Tennessee, but certainly as an instrumentality of the federal government, cooked up for the idea of control over navigation, what would be the ultimate solution in the TVA idea as extended into other states?

MR. OAKES: Well, if I understood the implication, it was to the effect that the property might be exempt on the basis that it was used for navigation purposes rather than for utility purposes.

MR. SAXE: No, undoubtedly, under the power of control of navigation, the federal government can impound and use the excess power and sell it. There it is exercising a governmental power, but it is a question under the constitution. So it would be immune to taxation.

MR. OAKES: The federal government as you indicated makes a contribution voluntarily. It also sets up a very stringent set of requirements for the municipalities which obtain power from the TVA, a set of requirements imposed upon those municipalities which I think you would find unexceptionable. The only question really would be whether or not the federal government would choose to carry out or extend its contributions in the other regional agencies

that are set up. Well, I, of course, am not in a position to answer that particular question.

J. B. Stokes (Tennessee): The gentleman may be interested in knowing the extent to which the state of Tennessee has collected taxes from the TVA. In July of 1937, I received a letter from one of the officials of the TVA in Knoxville, stating that they wanted an engagement with me to bring the first check covering the payment of taxes in Tennessee from power generated at Norris Dam, and also wanted releases on power generated at Wilson Dam, which is in Alabama. I later received a long-distance telephone call from another official in Muscle Shoals, Alabama, and then I received a telegram. Naturally, I looked forward with a great deal of anticipation to this unexpected income which would come to balance the state budget. Those two gentlemen got in their automobiles—one of them rode 200 miles and another one 125 miles — and came to Nashville to bring the check. The amount of the check, since the Norris Dam had not been running very long at that time, was $65.

We have had two checks from them since then, since the Norris Dam has been in full operation, which represented about a total from Norris and Wilson for the last year of a little over $11,000. Well, this year, we received from Norris and Pickwick, I believe—they left Wilson out of the statement—a total amount of tax of a little over $11,000, which is interesting in comparison to close to half a million dollars in gross receipts which is received from private utilities in the same area in the state of Tennessee. I wrote them and said that we derived a considerable amount of tax last year, a good amount of this $11,000, from water releases from Norris Dam to Wilson Dam, and that they hadn't included Wilson Dam in this statement. They answered my letter, saying, "It wasn't necessary to make any water releases from Norris Dam to Wilson Dam this year. The normal flow was sufficient to fulfill all the power requirements." The question in my mind is, how is a mere state official dealing with the federal government going to check an amount of that kind as you would in dealing with an ordinary corporation?

I just thought it might be interesting to you to know the extent to which the TVA as a practical proposition is contributing in taxes. If the commissioner from Alabama is here I would like to know the amount they are receiving down there. Anyway, I would like to get together with him on it.

Frontis H. Moore (Alabama): We are doing a little better in Alabama than the gentleman from Tennessee. They have contributed a little less than $5,000 in one year—contributed, you understand — $43,000 another year, and I believe the highest year is $64,000. But their statements are always very interesting. It is deduct here and deduct there, deduct what goes to Tennessee, what

goes to Mississippi, what goes to municipalities, and this and that and the other, and finally we have to take it and say, "Thank you." That has been our experience. There has been an immense amount of property taken off the taxation rolls. The revenue which would be lost to the city and county in particular and a good deal to the state would run into hundreds of thousands of dollars, but we are getting $64,000 and we think we are very fortunate.

HARLEY L. LUTZ (New Jersey): I am sure the audience must be tremendously impressed by these cases of the unparalleled beneficence of the federal government dealing with states. I did not arise, however, to discuss that particular subject, but rather to ask a couple of questions, one of Professor Simpson and one of Professor Oakes, with your permission.

Professor Simpson's conclusion was a very interesting one, and I think it is one that both the tax administrators and the public utility representatives want to consider more fully than we are allowed to in this brief discussion.

Professor Simpson's conclusion to the effect that regulation should be established on the basis of income before taxes and not after, raises an issue which in a certain sense is academic. It is the issue or the problem of sustaining the capital flow of new investment into this field. It is true that our whole taxation policy is one which completely ignores the problem of the flow of capital funds, and so the speaker can perhaps be excused for not raising that particular problem in his discussion. And it is further true that as long as we persist in the present insanity of taxation policy, it is an academic matter as to what happens to capital flow anywhere. Assuming, however, that this is merely a temporary aberration and not a permanent fixation, which has fallen, we might presume that eventually we shall come back to a more normal point of view, and then face the question of the effect of taxation in one manner or another upon the flow of investment funds.

With respect to private business, whether we adopt a rule that we shall proceed upon the basis of making income before taxes or not, it is perfectly obvious that the private investor is not going to follow that rule. He is going to judge of the risk and the possibility of return, in any enterprise that he is considering, on the net income basis after taxes have been computed. So the question comes up as to the possible effect upon investment attitude of a regulation policy which throws these taxes out of the expense account. The answer might be that the statutory rate of return, a rather liberal rate of return judged by the returns on many private investments, is a sufficient guarantee, and if we persist or continue to allow that liberal statutory rate of return, then we needn't worry about the comparative flow of investment funds into the public utility field.

But I think it would be interesting, either now or at a later time, for Professor Simpson to pursue that subject a bit further, at least for the purpose of assuring us whether or not he would regard the statutory rate of return, even if figured before taxes, as a sufficient one to sustain investment in the public utility field.

He may answer that question presently, and while I am on my feet, I will raise this rather simple question with Professor Oakes. I find myself in general agreement with his point of view and his conclusions, and I simply wanted to ask if he intended to include taxes on business income among the taxes which municipal utilities should pay? As I understood his discussion, it was limited to property taxation or to a tax on gross receipts more or less in lieu of the ordinary property taxes. If a municipal utility is operating in a state which also taxes private business on the basis of net income, I assume that the logic of your argument would require that the municipal utility should also be taxed on any profit from municipal operation under that business tax.

Those are the questions, Mr. Chairman.

CHAIRMAN FAGAN: Professor Simpson, do you care to make a reply?

MR. SIMPSON: Well, Mr. Chairman, I think Mr. Lutz has raised a very pertinent question there. I don't think that the policy of the regulating body would need to be affected by working on a basis of before taxes rather than after taxes. I would suppose the regulatory authority would still be free to adjust rates on the basis of any theory it might hold including the necessity of encouraging an adequate flow of capital.

As Professor Lutz implied, I think there is no doubt but that our past regulatory policies in recent years have greatly restricted any adequate flow of capital into the public utility field, and no doubt our taxes have had the same effect.

I would be inclined to think, though, that an adequate flow of new capital into railroad equipment and into the public utility field has been expressed much more by other policies outside both of the field of regulation and of taxation. If other conditions were right, I think we would have a fairly adequate flow of capital regardless of regulation or taxation. In any case, the regulatory authorities would have the same freedom that they now have to consider the encouragement of adequate capital, and to adjust their rates to accomplish that, and to accomplish any of the other present purposes of regulation.

MR. LUTZ: But, Mr. Chairman, as a matter of fact, the regulatory authority does not determine the rate of return. This is a matter fixed by statute and that becomes a matter of general public policy, and the point I wanted you to think about was not what the

regulatory body can do but the broader question of general policy with respect to investment return and its effect upon the flow of capital. I grant you that the regulatory body won't be necessarily affected by the situation.

MR. SIMPSON: Under present conditions, I hate to try to think of any broader policy of any kind.

MR. OAKES: So long as the net income tax is returned the way it is, apparently treated as a cost, I see no distinction between it in this particular connection and the tax on gross receipts, and I concede Professor Lutz's point.

CHAIRMAN FAGAN: Does anyone else care to enter into this discussion?

JOHN H. CARKIN (Oregon): In Oregon we haven't received any word of any possible checks as yet, and we have a large development comparable with the Tennessee Authority. As I understood Professor Oakes, he said that some provision had been made in the Tennessee Valley Authority law, and I wondered if that were to be a general policy of the government and if we might look forward to those checks.

MR. OAKES: I am not in a position to answer that question.

CHAIRMAN FAGAN: Is there any further discussion?

ANDERSON KETCHUM (Indiana): I rise for the purpose of adding to what Mr. Zoercher was about to say when his time was up. In Indiana this year we have placed a good many miles and several hundred thousand dollars worth of the Rural Electrification Corporation property under our plan of taxing municipal utilities. As those lines have been energized we have had little or no controversy with the corporations in placing them on the tax duplicate. The immediate question, of course, is the value of the property, and the question of their taxability goes right along with the municipal plants. I thought you might be glad to know that those rural electrification plants are included in our tax program.

RUPERT F. ASPLUND (New Mexico): I suppose it is difficult to conceive of a condition such as exists in a state like New Mexico, where we have about 60 municipalities, all small, as compared with those with which you are acquainted. Many of them are villages of very little taxable resources. But those communities have to have water, or become mere whistling posts. It is clearly evident to us in New Mexico that you couldn't make those utilities pay taxes. If the taxes were demanded it would require a raise in rates to such an extent that consumers would probably not be able to carry the burden of the tax rates, and you would revert to a desert condition in that particular community, as you understand the con-

dition in a state like New Mexico where water is so scarce that it is an absolute necessity to those villages to install their municipal plants. Private plants are perfectly willing to furnish light, but they don't care about undertaking the obligation of furnishing water to those communities. So the conclusion would be that you couldn't treat municipalities all alike under a policy of taxing them as you would private utilities in places where it would be possible to do so.

JAMES W. MARTIN (Kentucky): I have not been bribed by Mr. Oakes to make any defense of the position that he presented. As a matter of fact, I have never met him except through the medium of the famed questionnaire. I would like to say, however, in response to the position that Mr. Asplund has taken, that it seems to me these municipalities pay the bill anyway. That is to say, whether they pay it as a part of the cost of water service or whether they pay it through the medium of higher taxes, by way of subsidy to the water service, they pay it. The position taken in Mr. Oakes' discussion in respect to this particular matter seems to me to be very substantially sounder as a matter of bookkeeping as well as a matter of general public policy than the policy of providing this subsidy at the expense of local taxpayers on the basis of their property tax duplicate or through some other means that they may employ.

Incidentally, it is my recollection that they employ some excise taxes in New Mexico which are not very usual in the cities of other states, in addition indicating perhaps that revenues from the property tax may be rather scarce in some of the municipalities. It seems to me that the fact that the subsidy is being paid should at least be recognized in the accounting for the municipal water works business. That is true not only from the point of view of letting the public know what it is doing, so far as the municipal business is concerned, but it seems to me that it is true because of the danger of the so-called yardstick implications that may be invoked in the absence of such a policy. At best, as has been implied before, the yardstick has a good many dangers and this is an invitation, it seems to me, to an added danger which the yardstick in itself need not involve.

HENRY A. GUNDERSON (Wisconsin): I would like to ask Professor Simpson about his ideas of the assessment of the physical value of railroad property, whether he thinks it is proper to take into consideration the cost of reproduction less depreciation? The courts have indicated to us in Wisconsin that we cannot take the cost of reproduction less depreciation into consideration whatsoever, to any degree.

MR. SIMPSON: Mr. Chairman, I think most tax students are in agreement on that, that as long as we are going on the basis of

market value or as long as our tax valuation is based on that, we just have to face the fact that the reproduction costs or any kind of figures of valuation, may have no relation whatever to the present axiom of value of these properties. Conditions have changed. Competitive forms of transportation have developed. Regulation has reduced the rate of earnings, and until we have reached a point where to most of us what the property might have cost originally or what any present piecemeal physical valuation might amount to, there is no reason to assume that that has any relation whatever to the present value of the property.

Mr. Lutz: I find myself in agreement with Professor Simpson on a great many points, but if I correctly understood what he has just said, I feel obliged to enter a protest. It may be that I would be in a minority of one on this subject, but I think it is impossible to conceive of any application of the theory of value to this whole field *without* giving some weight to the investment side of the problem. As the law defines market value and as we commonly undertake to apply it, namely, the price that would be arrived at in a deal between a seller who is not obliged to sell and a buyer who is not obliged to buy, I think it is impossible to conceive of a deal or transaction that would result in a market price being established which did not take into account the seller's point of view. All of the theories of valuation which assume that the whole story is told when you have capitalized the present net income are of course taking into account simply the buyer's point of view. He is going to place his money into this property and naturally he is concerned simply with a capital investment which would represent a fair capitalized net income basis. But he can't buy it on that basis always, and he couldn't get it on that basis if he started out to build the same property. The seller has something to say about it, especially when he isn't forced to sell.

I think, as a matter of fact, we can apply our classroom approach to the theory of value here without distorting the case too much, and, of course, when we are in the classroom and are explaining to the immature minds how we conceive of market value, we always say that we have a seller who must take into account certain considerations pertinent to his point of view, as well as a buyer who looks at the matter simply from his point of view, and in the case of any manufactured product or anything else, what have you?

From the seller's point of view it is a question of what it cost him to produce that article or to supply that particular product. Of course, it very often happens, even in our classroom exposition, that we must concede the fact that the seller can't always get as much as he has put into his product. The buyer is not always willing to pay that much. But somewhere between the upper limit,

or between one limit fixed by the seller's side of the problem, and another limit set by the buyer's side of it, a compromise is reached.

What is the situation when you have a railroad property in which there is a certain fair investment, leaving out of account any padding or any deadwood or historical cost or anything else, but simply a problem of what it would cost to build this railroad now in new condition and then depreciate it to its present actual worth? That figure will differ from the capitalized net income.

Supposing you were going to sell that property and the seller doesn't have to sell it, he can hang on to it, and the buyer doesn't have to buy. I think the only possible rational solution of what the property would be worth is to say that somewhere between those limits a compromise is going to be reached if the property is transferred. Therefore, in approaching this problem of value for taxation, to me it is inconceivable that we should completely exclude the seller's point of view, and say, that this property, if it is transferred, is going to be transferred simply on the basis of what the buyer concedes it to be worth from the standpoint of capitalized net income.

I should answer the gentleman, therefore, by saying that beyond all question the investment cost is a factor. It isn't the controlling factor, neither is the capitalized present net income or past net income a controlling factor, and a wise tax commission will attempt to establish a level of assessment values that lie somewhere between these limits, and that their whole study of the past history and their whole diagnosis of the probable future history of that particular piece of property is a study which will bring them to a decision as to which of these elements in any given year of assessment they are going to give the greater weight to.

In some circumstances, it is true that the prospects of earnings, especially if they are declining, are going to make the seller take more of the loss; in other words, you are going to pull the valuation closer to the capitalized net income basis. Under other circumstances it is conceivable that exactly the reverse would happen, and that in view of expanding prospects of earnings, you would give greater weight to what it would cost the other fellow if he were going to reproduce exactly this property and go into that business for himself.

S. E. Forney (Ohio): It seems to me that with reference to the policy of taxing municipally-owned public utilities, we should bear in mind that the primary purpose of a tax system is the equitable distribution of the tax burden among those who should pay.

In Ohio we do not tax municipally-owned public utilities at all, and it seems to me that in order to make a fair distribution of the tax burden, those consumers who are served by municipally-owned plants ought to be required to contribute to the public support just

as well as those who are served by privately-owned plants. Our legislature recently enacted or re-enacted a tax on public utilities for poor relief purposes.

In the city of Columbus we have both a municipally-owned plant and a privately-owned plant. Some of the residents of that city are paying a part of that poor relief program. Others are not, because they are getting their service from a municipally-owned plant that bears no taxes at all. I believe that the municipally-owned utilities, especially when doing a commercial service, should be required to carry their share of the burden if we are to derive a part of our public revenue from public utilities.

As to the question of valuation of public utilities, I had some correspondence with Professor Simpson, when I was a member of the Ohio Tax Commission, on the basis of determining utilities. I found that in some cases all of the class theories put together in valuing some kinds of utilities weren't worth a Norris Dam. Wilson Dam, or any other kind of a damn. For instance, I refer to the method of valuing the interurban electric lines that were going to the junk heap year after year. They had no net income, there wasn't any basis on which you could determine a value, because they were going to the junk heap and going rapidly. We could see it by the decreased gross revenues that were coming in year after year. So we just had to put some kind of a value on as best we could, without applying any rule that might have been used for valuing a utility that had some net earning. In answering a letter from Professor Simpson, I told him that it seemed to me in determining the value of a public utility, the net income or net earnings from that utility had to be a very important factor, and not only the average over a term of years, but the trend of those net earnings, whether upward or downward, because we could see where these earnings were going downward, and we knew they were going downward to nothing, that the value of that property was diminishing year by year just as those earnings were diminishing. So in some cases you can't apply set rules in determining the value of a public utility. It is a difficult problem always.

I do agree with Professor Simpson that there is a vast difference between values for regulatory purposes and values for tax purposes. For instance, in those very lines that I referred to, the investment was there. Those who had invested their money in interurban lines certainly were entitled to a fair return. But the value that was there was not determined by the amount of the investment at all, nor did the regulation as to rate have anything whatever to do with the income. These factors had no bearing on that, because they were being put out of business by competition from the bus, the automobile, and other factors over which regulation had no control whatever.

Raymond D. Thomas (Oklahoma): I have been much interested in this discussion of tax-free municipal utilities. I live in a community which has no taxes. It is highly advertised as being a town without taxes. It is a town, however, having municipally-owned utilities. The reason it has no taxes is that charges for utility service take the place of municipal taxes. So that consumers of municipal services in my town are supporting the services of the city government.

We are going beyond that. You know there is a constitutional provision against taxing municipally-owned property. But in our pricing policy for utility services rendered by municipal utilities we are not only supporting the city government, fire department and the like, but we are building libraries, building sewer systems and so forth. Here is a case where a municipally-owned utility is contributing much more than it would contribute if it paid taxes.

I thought Professor Oakes might be interested in that. As we go into municipal ownership, my guess is that the advocates of municipal ownership are going to capitalize on that feature.

Mr. Lutz: What is the town?

Mr. Thomas: I live in Stillwater, Oklahoma.

Simeon E. Leland: I find myself in agreement with very much that Professor Simpson has said, with some of the remarks of Mr. Lutz earlier, and in particular accord with what he just said a minute ago. In order to save Dr. Simpson's time, so that he won't have to answer both of us, separately, I thought that I would add a few words to the discussion that Professor Lutz only started.

It seems to me that in part we are confusing the terms, and, like most debates upon important subjects, we haven't so precisely defined the terms that we use, that a great many difficulties and disagreements are implicit in a slightly different use of words and that that may be what is involved here. I think as tax men, we are prone to attach more importance to values for rate-making purposes and to think that those values have some propriety there, than the situation warrants. As a matter of economic fact, replacement costs or any other set of values have no place in intelligent regulation. That is simply a matter of maximizing gross returns.

It is folly, therefore, to give replacement and reproduction values as determined by utilities for regulating bodies, for whatever purpose they will, and however they like to spend their own and their staff's time, any means whatever in a valuation problem. The term "value" is used so generally — Mr. Forney pointed out there is a value for regulating purposes, there is a value for condemnation purposes, there is a value which the board of trade and the board of directors separately employ. As a matter of fact, there is only one value that we have any business talking about, and that is

market value, and that is the same for any and all purposes. The only point of difficulty is trying to arrive at the estimate of what that market value is for things which do not repeatedly sell, or sell often enough to establish a commodity price. We are too apt to talk about the market relationships of commodities, the units of which are interchangeable, such as bread or wheat or eggs, in similar terms to utilities and properties that sell themselves.

So we have to make various guesses, and among the things that we have to determine are what are the costs which would be involved in duplicating either the facilities which are being taxed or the costs which would be involved in duplicating economically necessary facilities which in the given state of the arts or the present state of technological improvement would be employed in providing the same or similar services which the people enjoy.

To the extent that our calculations in reproduction costs, less depreciation, are at all accurate, the thing that is being done there is to make an estimate of what that property would sell for, and to the extent that there is error, it is ordinarily due to failure to take account either of adequate depreciation on the one hand, or obsolescence on the other. Those are difficult things to accurately measure in practice, but so far as these theoretical considerations are concerned, there is no issue involved. Reproduction cost less depreciation and obsolescence is at least the attempt to arrive at the market value by determining what it would cost to reproduce those facilities or perhaps to sell identical units. That being in part true, it is important to give consideration to one other thing, that is, that the alternative use to which porperty can be put is one element which enters into market value, and is a thing which is to be taken into account and a thing which neither the capitalization of earnings nor the market value of securities takes into account.

Your railroad yards may be potential cites for skyscrapers or subdivisions. Your equipment may be sold on the market to other carriers, at more than it is carried on the books at reproduction cost or reproduction cost less depreciation, and so the alternative use and the alternative cost of those elements, land and equipment, find a rational and a reasonable place in the calculations of every investor in every person who is contemplating buying property, and in the mind of every tax administrator, and it follows along generally from there that that is an important element to take into account, and in considering the work of our regulatory bodies, it is well to think in those terms rather than in terms which simply mean that they are trying to estimate what a reasonable return on the investment will be, because that has nothing to do with their job or our job, and it is high time we think of these things in their proper light.

C. C. Brown (Oklahoma): I was very much interested in Professor Oakes' talk, but I find that perhaps we have different circumstances in various states. We have a constitutional prohibition, of course, in Oklahoma against the taxing of a municipality. That has been interpreted, of course, to apply to municipally-owned utilities. I want to say right here before I go any further, that personally, I am not in favor of municipally-owned utilities. But, as Mr. Thomas has said, we have several municipalities, in Oklahoma, where there is no ad valorem or property tax levy for city purposes, due to the fact that the revenue from the municipally-owned utilities takes care of all of the cost of the city government, and as he said, is used to build some libraries, parks, and so forth. However, our sales tax, a 2 per cent consumers sales tax levied on the consumer, is collected the same from those consumers purchasing from municipally-owned plants as it is from the public or privately-owned plant? With the exception of the prohibition in the constitution, they are treated much the same as other utilities.

I agree with Professor Oakes that under those conditions it does shift the tax burden, for the reason that in one particular town in which I happen to live, where there are two fairly good-sized refineries, and a great number of those employees rent a property to live in rather than own it, that the property tax is shifted, that is, for city purposes, from the owner of the property to the occupant of the property.

Mr. Simpson: May I just say a word in answer to Professor Lutz and Professor Leland? Let me make myself clear first, though. I don't mean to disparage the use of historical records of cost or engineering data on reproduction costs. No appraiser would undertake to appraise a property without first familiarizing himself with the past history and the fiscal situation of the property. But, sometimes that information is pertinent to present value and sometimes it isn't. The assessor must be able to distinguish between conditions where that information is pertinent and when it isn't. I think under most present conditions, that information has very greatly decreasing pertinency.

I hate to find Professor Lutz in disagreement with me. I don't know anyone whom I dislike to find in disagreement with me as much as Professor Lutz. It doesn't hurt me so much when Professor Leland disagrees, because I am used to that. But, I feel downright unhappy when I find myself in disagreement with Professor Lutz.

I would like to find some ground on which we can agree. I think it might be this. If Professor Lutz came to Chicago and undertook to buy real estate on the basis of reproduction cost, he would go bankrupt in a week. I think probably we can both agree on that.

CHAIRMAN FAGAN: Gentlemen, I believe the hour has past 12 o'clock. I notice that our discussion is tending toward the same line of discussion that is scheduled for the two o'clock session this afternoon, railroad tax problems. So, however incomplete we may be in our thoughts at this point, I imagine they can be taken up more completely at that time. I enjoyed the pleasure of presiding over you this morning and thank you, Dr. Leland, for the privilege.

CHAIRMAN LELAND: I have only two things to call to your attention, and one is to announce that the registrations so far are in excess of 500, and that we have over 40 states and Canadian provinces represented in the registration. That leads me to believe that our total attendance here will run well above the usual mark for these conferences.

The next thing I want you to do is to buy tickets for the dinner which will be held tonight. I have heard some of you complaining about the price of food at these dinners. You haven't complained nearly as much as I did when I first heard it. But it is explainable only by the fact that this is a well-organized if not well-regulated town, and in the difficulties with the labor unions, these prices and these costs have been uniformly imposed upon all the places within the city. So far as the price of the dinner is concerned, there is no way out of that, so long as the convention meets in Detroit. I think that is a matter of interest, it is one of these things that your committee was up against, but we thought that rather than forego the opportunity of meeting and maximizing our opportunity for discussion, that these dinner meetings might be highly enjoyable as well as expensive.

We will meet in our round tables this afternoon at 2 o'clock at the places indicated on the program. We will convene back here in this room, then, tonight at 6:30 to discuss some of the problems from the taxpayers point of view. I think you will find this a very interesting session. There is some good music to be provided tonight by a very competent and qualified high school orchestra, and that will not interfere with the speaking or your pleasure at dinner, but rather contribute to it. We hope that you will find this session as enjoyable as any we have had to date. Thank you.

(The meeting thereupon adjourned at twelve-ten o'clock.)

SIXTH SESSION

Tuesday, October 25, 2:00 P. M.

ROUND TABLE IV

Railroad Tax Problems

Presiding Officer

Simeon E. Leland, Professor of Public Finance, Univ. of Chicago; Chairman, Illinois Tax Commission.

Recording Secretary

Gertrude Alexander, Secretary, Illinois Tax Commission.

Opening remarks and basis for discussion by Simeon E. Leland.

Participants:

J. H. Thayer Martin, State Tax Commissioner, New Jersey.

George W. Mitchell, Director of Research, Illinois Tax Commission.

W. Hall Wallace, Valuation Engineer, Mississippi Tax Commission.

E. A. McCrary, Tax Commissioner, Northern Pacific Railway Company.

M. M. Daugherty, Economist, University of Delaware.

George E. Tunell, Commissioner of Taxes, The Atchison, Topeka and Santa Fe Railway System.

G. E. Zubord, Real Estate Agent, Louisville & Nashville Railroad Company.

D. H. Worrall, Tax Agent, The Pennsylvania Railroad.

James W. Martin, Kentucky Commissioner of Revenue and Director, Bureau of Business Research.

Presiding Officer: The record will show that we started this round table on time.

Last year we had a very interesting round table, I thought, on railroad taxation. It has been a subject that, as some of you know, has interested me for some little time. We have four topics related

to railroad assessments on the program for this afternoon. Last year there was considerable interest in the assessment of railroad property in New Jersey; it has seemed to me that we might well start the discussion by hearing from our good friend Commissioner Thayer Martin of New Jersey. He is going to talk on "Alternative Use as a Valuation Factor," as indicative of the philosophy which he thinks prevails in his state. Now, we have a lot of fireworks here this afternoon and the orders were that you were all to be frisked when you came in so that our battle would be purely a verbal one. If we are to run through this session with dispatch, it is desirable that we stick pretty close to our time limits in order that there may be some time for discussion at the end. I am hoping that it will take no more than two hours to dispose of such papers as have been written. To the extent that it is possible, I suggest you dispense with your remarks as you have written them and discuss the subject matter extemporaneously. Let's try to coast along in zephyr style with the streamliners' speed and wind resistance so that we may cover the formal part of this program, leaving those who have guns and ammunition with ample time to shoot at the targets, if not to hit them. Mr. Martin, will you start the discussion.

J. H. THAYER MARTIN: I didn't get here in time to participate very much in the session this morning but I understand both this morning and yesterday there was quite a little discussion of railroad taxation, and some about alternative use this morning. It may be that my prepared paper doesn't go as deeply into the details of alternative use as some of you folks would like but perhaps I can interject a little as I go along here and there on that particular point. My paper is short enough so that it won't take the whole twenty minutes, and if I interpolate a bit I will endeavor to keep the whole thing within the twenty minutes.

ALTERNATIVE USE AS A VALUATION FACTOR

J. H. THAYER MARTIN

State Tax Commissioner, New Jersey

The title of this paper as assigned by your president was intended to develop a discussion of the controversy over the method of taxing railroads used in New Jersey as contrasted with the formula system used in some states. New Jersey's objection to a formula system is that any such system does, in fact, transplant out of New Jersey taxation a large part of the tremendous value of the railroad terminal properties on the Jersey side of the New York harbor.

I might say, your President said I'd refer to what was perhaps a Jersey theory on this subject. I know that is a Jersey theory or school of thought.

New Jersey taxes railroad property by assessing it at true value or as near true value as can be estimated, not, however in the case of real estate, on any higher basis than comparable adjoining non-railroad property is assessed and taxed locally. To the valuation as so determined, the local tax rate is applied for all real estate except the main stem. All the remaining property used for railroad purposes, including the main stem right of way is taxed at the average local rate. In other words, New Jersey railroad property is taxed on substantially the same basis as all other real estate, except that the appraised value of the franchise is also taxed at the average local rate. On account of the depression, however, the valuation of the franchise has been so greatly reduced that it is no longer a substantial matter of controversy.

I might say that a large number of the railroads in New Jersey today we assess only $1000 on their franchise and that means a $40 tax on the franchise, or a $45 tax.

In valuing the tangible property, New Jersey endeavors to assess it at a sum not exceeding the amount for which the actual physical property could, in fact, be sold, either as a whole or in parcels. We assume a sale to the highest bidder, even though the prospective purchase may be in contemplation of turning the physical property to some other use than that of a railroad.

Many of the states,—in fact, most of the eastern states,—use the same or a substantially similar method of taxing railroad property. On the other hand, some states, especially in the west, follow what is called a formula system in which they determine what they term the commercial value of an entire railroad system by a study of the market value of its securities and by capitalizing its earnings, and then after fixing the system value, they allocate to the state in question what is assumed to be the fair share of that state determined by a formula including such elements as track miles and traffic miles, source of revenue, reproduction value, and other elements more or less arbitrarily weighted.

The formula method of assessing railroads was devised originally to enable states where the railroad property itself had relatively little value, to reach for taxation purposes a part of the franchise value. As applied for that purpose, it was probably legitimate.

In the days of railroad prosperity when the franchise had a substantial value, some of the franchise value was properly taxable in every state through which the system ran. But its application in New Jersey is now demanded by the railroads for the reverse purpose of reducing the taxable value of their physical property actually located in the state.

The railroad argument in brief is that no matter how valuable its tangible property, the whole of that property cannot be worth more than the capitalized railroad earnings. To carry that argu-

ment out logically, if the railroad system is not earning its operating expenses, and there is therefore no operating income to capitalize, the tangible property of the railroad, no matter how valuable, would not be taxable at all.

Now, there might be some plausibility in such an argument if the railroad property could not be used for any other purpose. But in New Jersey, we know that all of the most valuable portion of the railroad property, namely, the terminals on the Hudson River opposite New York City, could be sold for other uses, and we can see no reason why that property is not subject to taxation at the same rate as other adjacent property, at a valuation not exceeding what the railroad terminal property would bring if offered for sale for other purposes.

I might say here that this terminal property, as we call it, of the railroads amounts to more than one-half of the total assessed railroad property in the whole state. Therefore, the value of the terminal property is the seed of our controversy in New Jersey.

There is a sufficient market for that class of property, so that we are reasonably sure of our property valuations. There is a great deal of non-railroad property adjoining the railroad terminals, the salable value of which is known. We do not assess the railroad terminal property on any higher basis than that of the adjoining non-railroad property, and we believe no one has a right to complain of such a method of taxation.

These railroad terminal yards in Jersey City are all the identical type of property that is gobbled up whenever a piece is offered for sale anywhere along that section. They are gobbled up for steamer terminals or similar actual commercial uses. There is a market—an actual market—for that property—the bare land, and the bare land value, as I said, represents more than half of our total valuation.

If a railroad system chooses to use valuable New York Harbor property as its terminal, that property is surely taxable at no less a sum than would be the case if someone else were the owner, and it is immaterial whether or not the particular railroad owning the terminal is earning its operating expenses.

In fact, many of the terminals are not owned by, and are not even taxed against, the foreign railroad corporation which, by some kind of operating agreement, gets the benefit of this New York outlet for its entire widespread system.

The railroad argument on that point is that the railroads have no right or power to sell any of their property, and therefore that the state has no right to tax it at the value the property might have if applied to other purposes.

Without stopping to cite the legal authorities, our answer to that is that if an item of railorad property can be used to better advantage for some other purpose, there is no constitutional power in government to withhold the right to sell unless the government

permits the railroad to earn sufficient income to justify the retention of that item in railroad use, at its real value.

The railroads further argue that their title to railroad property is not a complete title, such as an ordinary owner has; it is subject to the duty of furnishing service to the public, and therefore that the public, in effect, has a qualified title or interest in the property, and that the railroads cannot be taxed on their ownership for that part of the value which is really held by the public.

Our answer to that is that the public interest referred to in this argument is nation-wide, but that the state has the right to tax all the property within its borders at its true value; and that if the outside public has such an interest in the property as the railroads claim, that interest is nevertheless subject to taxation, and the railroads must be allowed to earn sufficient income to pay that tax; and if because of business conditions, the property cannot in railroad use earn both its taxes and a reasonable return for the investors, no governmental power can long prevent the liquidation of that railroad in bankruptcy, and the actual sale of its property to those who can use it for more profitable purposes.

With respect to alternate use values, we know that if the waterfront property in Jersey City now held by the railroads were leased from railroad use it would all be gobbled up for the use of ocean-going water traffic or other uses based on the New York Harbor. We know that quantities of the adjacent hinterland would be eagerly acquired for warehouses and other port facilities. And we know from actual sales of comparable land in the vicinity, that the prices at which railroad terminal property could be sold are at least as great as our assessed values.

The foregoing discussion of the terminal real estate covers over half of the total railroad valuation in New Jersey.

The next largest item of valuation comprises the main-line rights of way. The rights of way are not assessed at a higher rate than adjoining property is assessed for local taxes, and so far as we know, are not assessed higher than the adjoining property would bring if offered for sale. We believe that the rights of way not only would be salable in parcels but would be salable as a whole. We believe that if any of the railroads suspended operations, the state would be willing to step in and take over its main line for highway purposes, at the assessed value. We are satisfied that this is a fact because every one of the main lines passes through or connects sections where additional highways would be of advantage, and we know from experience that wherever a right of way for highway purposes was acquired in any part of the state, it actually did cost approximately three times the assessed valuation of a comparable part of the nearest neighboring railroad. Similar use of abandoned railroads for highways has already been made elsewhere.

And I might say that the state now is seriously considering, or some of the state officials are seriously considering, making an offer to some of the railroad companies to buy some of their railroad rights of way for highway purposes and the railroads, if the state does get around to that, the railroads will then have to make a choice between selling to the state or admitting that their right of way is worth more to them than the assessed value.

The bare land values comprising the terminal properties and the rights of way already discussed represent substantially three-fourths of the total railroad assessment in New Jersey. The points discussed in connection with the terminal property are equally applicable to the rights of way, assuming only that we are correct in our appraisal of these values.

A somewhat different question arises in the case of the railroad structures. Except for the bridges, and warehouses, most of them are not capable of diversion to other profitable uses, and in these cases, unless the structure appears to be capable of earning its own carrying charges as a part of the railroad system, we do write off a large part of the original cost under the name of functional depreciation. We do not attempt this, however, in case of all types of railroad structures. For instance, in the city of Newark, the Pennsylvania has expended several million dollars in the new passenger station, which was built with a capacity to take care of much more than the present volume of traffic. We know that structure is not now producing revenue commensurate to its cost, but we do not believe that that investment for future prospective needs should be subsidized by excluding it from taxation in the interim.

The same reason applies to the heavy expenditures made by the Pennsylvania and the Lackawanna in electrification. We believe electrification has proved profitable, and we do not believe the investment in it should be scaled down for tax purposes—even though it couldn't be sold for any other profitable use at anything but a scrap value.

The only large items of taxable railroad property not already discussed are the franchise and the movable equipment. Because of the shrinkage in railroad earnings we have reduced our assessment of the franchises to figures which we believe even the railroad counsel do not seriously criticize.

The railroads are not contesting our assessments on movable equipment. That now in use has been depreciated, and the rolling stock tied up and out of use, has been cut down by obsolescence allowance to a point where the railroads do not complain.

We believe that our system of taxing railroads in the manner already described is entirely fair both to the railroad investors and to the traveling public.

Comment is sometimes made on the fact that the New Jersey tax per mile of railroad is higher than the tax in any other state. The

first answer to that is that no other state has as large a percentage of its railroad property made up of such intensely valuable land as that bordering the Hudson fronting New York City.

A further answer is that the New Jersey rate on all real estate is inordinately high.

While the railroad litigation attacks solely our valuation, their real complaint is the size of their bill — which is due not to our valuation but to our high tax rate—and if that were reduced by a reduction of the tax rate, I do not believe they would any longer complain of our method of valuation.

This brings us to one feature of the New Jersey railroad tax situation that deserves criticism. The tax rate applied to railroad property is substantially the same as the local rate. As already mentioned, it is either precisely the local rate (in the case of the second-class property), or as to some of the property, the average local rate. This rate, however, is undeniably much higher than it would be if all personal property throughout the state, both tangible and intangible, were assessed at fair value, and taxed at some rate, even though a much lower rate than that applied to real estate. However, this discrimination does not affect simply the railroads. It affects all real property throughout the state.

New Jersey is endeavoring through a tax revision commission to remedy this unfair treatment of real estate. If successful, this would solve the railroad tax litigation because the railroads are not really concerned so much over the *way* they are taxed as over the *amount* they are taxed, and a more equitable tax system in New Jersey would reduce the amount of railroad taxes by lowering the rate at the same time that it would reduce all other real estate taxes.

Referring back to the mention of transplanting values by the use of formulas, we in New Jersey made a check of all the different formulas for apportionment proposed by the railroad counsel in the years of litigation—and that has been a large number. We know from our own study how much of the railroad value of any road is located in each of the counties through which the road operates, and we know that approximately half of the total value is located in Hudson County. We found that every formula proposed would abstract nearly one-half of the Hudson County values (one of them 60%), and transplant most of these to the rural counties of the state, in some instances giving rural counties five or six times the value that actually was found in these counties. As stated earlier, this might be reasonable in spreading excess values solely attributable to the railroad franchise, but it is obviously unfair as applied to the real value of tangible property physically located in a particular taxing district.

Presiding Officer: We are deeply grateful to Commissioner Martin for the thoroughgoing presentation he has made and we

hope that when the time for discussion comes, you will call him back to take up some of the things that I know he would have said had his time been unlimited.

Now, one of the variants that we can consider in connection with the assessment of railroads is whether we are going to tax these concerns on the basis of the property they own or whether the approach will be, let's say, that of the operating business unit on the basis of the property that they use. It gives me a great deal of pleasure to present the next speaker, the director of research of the Illinois Tax Commission.

George W. Mitchell: This paper is addressed to a rather technical problem and the answer to this technical problem is rather short, provided you understand the assumption and the theory behind the answer, so that I have incorporated into this paper a good bit of background and apparently irrelevant material in an attempt to get my point of view sufficiently into the discussion so that you can understand the reasoning involved.

USE VS. OWNERSHIP AS A BASIS FOR TAXATION

GEORGE W. MITCHELL
Director of Research, Illinois Tax Commission

Economic developments in the transportation industry during the past decade have contributed in large measure to an increased reliance on factual considerations for determining assessments of railroad property. General depressed business conditions, the powerful bargaining position of railway labor, and the growth of competing modes of transportation, such as pipe lines, motor trucks, water ways and electric transmission lines have forced the railroads into an unenviable position. Railroad costs have a stubborn inflexibility that is only matched by the rigidities of the rate structure. This results in a combination that delays and postpones any effective adjustment to present conditions. One of the most inflexible cost items is the property tax bill. Many regulated enterprises have in the past and some still regard the size of their tax burden as relatively immaterial. A larger assessment, they reasoned, promotes good will among the local governments and can be absorbed in higher rates approved by the regulating body.[1] Few if any carriers now subscribe to this position.

The railroad managements regard taxes as any other item of cost. In their efforts to reach a more favorable operating position, they

[1] This position, of course, rests upon the doubtful assumption that the demand for the industry's service is relatively inelastic and that the increase in cost due to increased tax burden will have little or no effect upon the volume of traffic.

attack the problem of reducing taxes with the same determination and acumen employed to effect operating economies, to reduce wage rates, to scale down fixed charges, or to obtain more productive tariffs. Tax commissions and other assessors are forced to resist reductions in railroad assessments because of the necessity of obtaining as much revenue as possible for their governments. There would be less opposition if these assessments were not so important a part of the local tax base. The financing of the schools, cities, and other local units with the grants the states and federal government are disposed to make and the remnants of the general property tax has placed a heavy premium on those remnants. The railroad and utility assessments are relatively more important now than ever before.[2]

It has therefore been increasingly necessary for railroads to establish lower values for their properties in terms of the factors recognized by statutes and decisions of state and federal courts. More than ever both railroads and assessors look upon assessments as dependent upon factual considerations. It is incumbent upon the railroads today to prove their case in conclusive terms before they can obtain any consideration from assessment officials. The declining railroad fortunes have eliminated any satisfactory solution in terms of that sacred bull, *Last Year's Assessment*, or his handmaiden the *Judgment of the Commission.* This is truly fortunate since there is scant justification for perpetuating the frequent blunders or prejudices of previous assessing agencies. Measurable quantities are of paramount significance in deciding how far a railroad can go toward reducing its tax costs or how far an assessor can go in bolstering up his tax base with the railroad assessments. These objective facts, it is now quite generally recognized, relate to methods of reaching a unit value for railroad property and allocating this unit value to the states in which the railroad may operate. Generally assessors and the majority of railroad tax attorneys are disposed to give consideration to at least three factors in determining the unit value: capitalized earnings, stock and bond values, and the cost of reproduction less depreciation and to several methods of allocating the system value among the states. These procedures may be applied to a unit that represents ownership or a unit that represents use. The considerations that affect the choice between these two alternatives constitute the subject matter of this paper.

The unit method of assessment as contrasted with a physical valuation of inventorial items creates the problems discussed herein.

[2] The final gesture of resistance to reduced railroad assessments is the frequently reported fact that petitions for abandonment of railway lines are primarily opposed by the localities they serve because of the loss in tax revenue. The methods of distributing railway valuations within the states contribute to such a situation; generally a uniform rate of assessment per mile of road or track is applied over main and branch lines alike.

The unit rule applies to a going concern, an operating unit with central management and control. The taxable property and rights going to make up this unit include leased as well as owned items. In theory, the value obtained reflects the earning capacity of all elements in the operating unit.[3] A railroad is not particularly different from an industrial concern in the proportion or in the amount of equipment and facilities used but not owned. If the assessment techniques commonly applied to industrial property were uniformly used for railroads the issues treated in this discussion would not arise. These techniques for practical and legal reasons are not applicable to the railroad assessment problems.

The most common types of property used but not owned by the railroad unit may be grouped under four headings:

(1) Leased lines. These are railroads leased for periods ranging from fifty to a thousand years. In most cases the property is operated as an integral part of the lessee's system. Sometimes separate operating statistics are kept for the leased property even though the management arranges to enjoy the advantages of unified operation through a close working agreement. It is common for the lessee to own all or a substantial portion of the common stock of the lessor corporation.

(2) Leased facilities such as freight houses, yard and terminal trackage used exclusively by lessee. Such facilities are frequently owned by operating railroads who do a substantial business with the lessee and may have been specifically provided to promote and expand that business.

(3) Rolling stock of other carriers and private car line companies. Approximately twenty-five per cent of the freight cars owned by class I railroads are used by companies other than the owners. Private car lines furnish railroads with about fifteen per cent of the total number of cars in service.[4]

(4) Joint facilities. Many investments in railroad property are jointly owned, maintained, and used. Where such facilities consist of an interlocker, a short stretch of track or a warehouse, the arrangement consists of nothing more than an operating agreement.

[3] Even in its earliest applications recognition was given to the values growing out of unified operation. "The unit is a unit of use and management and the horses, wagons, safes, pouches and furniture, the contracts for transportation facilities, the capital necessary to carry on the business . . . in Ohio possessed a value in combination and from use in connection with property and capital elsewhere. . . ." *Adams Express Co.* v. *Ohio State Auditor*, 165 U. S. 222.

[4] There are approximately 1,760,000 freight cars in use by class I railways. There are, in addition, 287,000 frieght cars owned by private car lines. The car hire accounts indicate per diem payments in 1936 of about $170,000,000; these represent the annual exchange of approximately 455,000 cars. Cf. *Statistics of Railways in the United States*, 1936, pp. 5-19; S-85.

Where they involve the acquisition and operation of terminals or belt lines, it is common practice to create a lessor corporation which holds title to the property even though its participation in railroad operations is on a limited scale. There are several such companies in the United States.

It is apparent from this summary that railroads use many facilities owned by other carriers. Whether the lessor or lessee shall be assessed for operating property is of primary importance as it affects the relationships among them. In many instances any change from the present arrangement would mean a disrupting of the lease terms. There are cases in which a failure voluntarily to amend a lease would result in gross injustice to one of the parties. There is some doubt that the Golden Rule would be universally recognized in such situations, for although the railroads must be credited in this era with being among our most enlightened taxpayers, between themselves they still seem to resort to practices sometimes described as predatory.[5]

How will the income factor react to assessment on the basis of use rather than ownership? Railroad accounts since 1914 have been prescribed by the Interstate Commerce Commission. These accounts make it possible to apply the same standards for the determination of net income to all carriers. In the income statement prescribed by the Interstate Commerce Commission "railway operating income" is the figure reflecting most nearly the net available from property used irrespective of ownership. This figure represents income before adding or deducting the balances payable or receivable from the hire of equipment and joint facility rent income or rents. To obtain a net figure to reach the capitalized value of property used, it is only necessary to adjust the "railway operating income" by an amount sufficient to recognize that portion of rents paid which is necessary for capital replacement and repair. This adjustment will consist in deducting from "railway operating income" the portion of rents payable available for repair and depreciation and the portion of rents receivable available for interest and dividends.[6] If it is desired to utilize the basis of ownership rather than use, the adjustment should begin with "net railway operating income," adding thereto income from lease of road and equipment.

[5] Had this paper been delivered some twenty years ago, a considerable amount of attention would need to have been given to property which railroads own but do not use in the railroad business and to drawing a line between carrier and non-carrier operations. Fortunately for the assessor the Interstate Commerce Commission has done a great deal toward distinguishing between carrier and non-carrier activities and in divorcing these correlated interests from actual railroad operation.

[6] To adjust the joint facility debits and credits along the same lines will require the deduction of that part of the joint facility debits covering maintenance, taxes and capital replacement and that part of joint facility credits covering interest and dividends. The differences in terms of joint facility agreements will require that each case be separately considered.

It appears to be the theory of the Interstate Commerce Commission accounts that they move from a position in which the accounts represent the income and expenses from the operation of all property used to a situation in which they represent the income and expenses connected with the property owned. This adjustment of earnings to represent the net of property used or owned can only be made on an approximate basis but a higher degree of confidence can be placed in the result than attaches to many accepted practices in formula assessment. A good example is the use of past earnings to represent future earnings.[7] It should be borne in mind of course that these adjustments relate solely to property used in railroad operations. If the assesment law requires valuation of non-operating property other accounts must be considered.

How will the employment of the use or ownership criterion affect the stock and bond value? It takes all of the equities in a going concern to represent the value of the property for tax purposes. Equities are by no means confined to stock and bond holders. All having any claim against the tangible and intangible assets of the corporation as of a given date are entitled to their proportionate share. Furthermore, there are many equities whose interests are hidden. There is little doubt in many quarters that railway labor possesses, in effect, a large measure of equitable interest in the railroads. In times past, if not now, it has been taken for granted that certain shippers had a vested interest in the railroads serving them. There are also many instances in which the management has a far greater equity in the road than would appear from its holding of securities. Any thorough study of the value of a going concern through an appraisal of the value of the interests to which the railroad is owing money or rights should take all these factors into consideration. As a matter of practice, however, there has been

[7] In recent years great weight has been attached to the earnings factor, particularly by railroad tax representatives. Their position implicitly assumes that "net railway operating income" as defined in the Interstate Commerce Commission Accounts provides an exact answer to the question, what have been the real earnings? As a matter of fact, in at least one important respect this assumption is severely strained — the accounting for capital replacement. Very few carriers charge depreciation on any accounts excepting rolling stock. In lieu of depreciation on other capital investments they charge retirements when replaced, to operation and those not replaced to profit and loss. While the industry was growing and expanding this assumption did small violence to the facts, for once a railroad is in operation it tends to be maintained at about the same percent of condition at all times. However, with the industry, as a whole, in a declining state and abandoning much of its mileage and many of its facilities, the question of capital replacement in the absence of an adequate depreciation policy raises considerable question as to what the true earnings have been. Even though the assessor has the reply that abandonments already made are not indicative as far as future earnings are concerned, if a railroad has the prospect of recurring retirements some weight should be given thereto in determining the amount of net income for capitalization.

scant recognition of any equities other than those of stock holders, bond holders, and note holders.

The adjustment of stock and bond value to the ownership basis is of course immediately accomplished inasmuch as these stock and bond values are presumed to reflect the value of the property owned and the relative profitableness or unprofitableness of any lease arrangements.

To place the stock and bond unit valuation on a use basis requires that the assessor determine a value for all items of equipment and facility that the carrier uses but does not own and likewise on those which it owns but does not use. This offers no particular problem. Accurate records are kept showing the number of cars interchanged among railroads and mileage traveled by cars of private car line companies. For leased lines or facilities, the terms of the lease must be regarded as controlling the value of the property involved. It will immediately become apparent that many leases represent the bargaining strength of the parties or conditions which prevailed in other times. Judged in terms of present day conditions such leases will not accurately reflect the value of the property. In these cases, it is possible to charge the lessee with the value of his leasehold estate, making corresponding allowance to the lessor. By the same reasoning the lessor's favorable leases would need an upward revision in the assessment process, with a credit to the unfortunate lessee.

How will the employment of the use or ownership criterion affect the Interstate Commerce Commission's appraisal of the property in terms of its reproduction cost less depreciation? No particular problem is encountered here, inasmuch as the reproduction values are applied to an inventory that can be assembled on either basis. As a matter of fact, in making adjustments of the stock and bond value to reflect use rather than ownership, valuations of certain facilities can best be obtained from the Interstate Commerce Commission valuation record.

The allocation factors most commonly employed relate more to use factors than to those of ownership. The theory of allocation rests entirely on the assumption that the unit to be allocated is an operating entity. The majority of the factors commonly employed are statistics derived from the use of facilities without regard to ownership. Value is attributed to those states in which operating activity is shown to be greatest. The oldest elements in the allocation factor, namely the mileage combinations, can be obtained on either basis. Either all-track miles or miles of road can be readily adjusted in such a way as to show the number of miles owned or operated.[8] Gross revenues, car and locomotive miles, ton miles,

[8] Trackage rights occupy an anomalous position; they reflect joint or multiple use of road or trackage without necessarily implying that the value

passenger miles, are all definitely use factors and relate to the operation of property regardless of ownership. It is doubtful if there is any satisfactory method for adjusting these factors so as to represent ownership. Allocation of property owned in terms of them represents a logical inconsistency. Cost of reproduction as an allocation factor can be satisfactorily adjusted to either basis.

The soundest policy for both the railroads and the assessors is a combination of the use and ownership criteria. For leased lines and major leased facilities it seems clear that the use should govern. Most of the statistics and data relative to such property must be obtained through the accounts of the using company and usually they are so completely identified with the system account that it is impossible to make anything other than a purely arbitrary separation. When operating accounts can be separated, the validity of the separation becomes a question of the effect of the intercorporate relationship on the volume and profitableness of operation. If the leased property would enjoy the same advantages and the same handicaps without its connection with the lessee operator there is something to be said for a separate valuation. However, the mere fact of acquired control implies some advantage to either or both parties and that advantage should be reflected in their consolidated account. Unless the assessor is in a position to appraise the contribution of each of these companies to the whole, he will obtain the best results by combining them.

With respect to rolling stock there is little practical justification for employing the use basis rather than the ownership as far as cars of other carriers are concerned. Ownership has been employed in most states and a shift to use would involve some readjustments which might have serious repercussions for a few individual roads and states, but would be of little general importance. There are at least two situations which warrant the assessment on a use basis. Where a carrier just enters a state at the end of its line in order to have access to an important terminal point, and especially when such access is afforded by a trackage right agreement, the only property assessable in the terminal state is the equipment running into it and the value of the franchise to do business there. If, as is frequently the case, the carrier uses a substantial number of cars belonging to railroads not operating in that state, an ownership assessment will deprive the terminal state of its legitimate revenues. The other situation involves states served by carriers whose operating statement shows a large debit balance in the per diem car hire account. These roads are using more rolling stock than they

of the property is increased in the same proportion as the number of users. This presumption is recognized as sound if trackage rights are included in the track allocation factor with a weight equal to mileage exclusively used or operated.

own. The assessor will do well to consider employing the use rather than the ownership criterion for them. Within these limitations, it appears that no state is in a position to lose its just revenue by adopting the ownership rather than the use basis for cars owned by other carriers. Cars of private car lines present a different situation. As far as the assessors are concerned there is a saving in time and effort if these assessments are placed against the railroad company which uses the cars. There may be some quibbling as to whether railroads actually use the cars from which they derive an operating revenue and for which they pay a substantial rental, but abstracting from any legal difficulties in this connection the simplest method would be one which would include this property as a part of the railroad assessment. Inasmuch as railroads keep a complete financial and operating record of the private car lines' equipment, it would not seriously inconvenience either party if the railroads simply withheld the car line portion of the taxes when making their rental settlement.[9] The railroad would seem to be justified in passing on to the car line company as a fair estimate of the tax, the amount of assessment on such cars times the average effective tax rate for the railroad's property in the year in question. The question of joint facilities owned by jointly controlled lessor corporations primarily to provide terminal and switching facilities in metropolitan areas presents a very interesting problem. In short, it resolves itself into the question of whether the state in which these terminal facilities are located shall tax the entire value or shall share it with all the states in which the users of the facility operate. The ownership basis would entitle the state of situs to allocate the entire value to itself and not share with the bridge states. There are instances in which the amount of money involved in these two methods is substantial enough to interest the bridge states in acquiring a portion of the value of terminal property. No doubt the terminal states are equally desirous of keeping such property in their own bailiwick. It should be noted that wherever such terminal facilities are an integral part of an operating unit no question is raised when they are spread over the entire system. It is only when they are separated, incorporated, and owned by lessor railroad companies that the terminal states can appropriate the entire property for their own assessment.

To illustrate. In one of our metropolitan areas a large railroad system owns and operates extensive terminal facilities. The value

[9] This system is of course used in several states and works with reasonable convenience to all parties concerned. The separate assessment of car line rolling stock and distribution of their value over an extensive road mileage results in absurdly small values in many taxing districts. The consequence of this is so large a volume of public bookkeeping as to offset much of the revenues collected by the local governments on these assessments.

and earnings of these properties are included in the unit assessment and allocated to the states of operation by the use of factors mentioned above. It is possible that the terminal state gets its just share of the value of the terminal facilities by the use of this method but it certainly would get much more if the corporate organization were similar to that of another terminal in the same city. The other terminal is a joint facility owned by three large systems. It accommodates these companies and one tenant. Under the ownership rule the entire value of this property is taxed in the terminal state and in the district in which it is situated, but under the use rule it could be divided among the using companies and allocated to all states in which they operate, for in a very real sense this terminal property is used by the three roads and their tenant. To cap this interesting situation consider that at least one of these carriers has large terminals in other metropolitan areas which are integral parts of its system and therefore included in its unit value. If any one of these railroads had been owner and joint user, an entirely different result would be reached from a formula assessment since the adding of the terminal facilities into any one of these systems would have had slight effect on the allocation factors in common use (apart from reproduction cost).

The theory of valuation embodied in the unit rule assessment and applied to a going concern engaged in the railroad business seems clearly to require a thoroughgoing application of the use alternative. There are furthermore some practical justifications for the adoption of this method. Most of the adjustments involved in a shift from ownership to use will affect the distribution of assessments among railroads and to the extent this disturbs existing lease and contract agreements will require ample justification. In a few important instances the distribution of values among the states is at issue and here nothing short of adjustments in corporate organization or an appeal to the use criterion will conform to the implication of the unit rule.

Presiding Officer: I think we are now on our way, gentlemen. The next fireworks come from another part of the country. One of the problems that we are faced with as administrators is what happens when all of the theories that we think we have don't work, and give railroads lower assessments than would be justified if they are to continue operation. I have asked Mr. Wallace, chief valuation engineer of the Mississippi Tax Commission, to address his remarks to the question as to whether or not, regardless of theories or formulae, commissions are justified in using the judgment criterion in adopting minimum values for railroads which continue to operate. Mr. Wallace, we would like to hear from you.

MINIMUM ASSESSMENTS FOR RAILROADS

W. HALL WALLACE

Valuation Engineer, Mississippi Tax Commission

Are commissions justified in adopting minimum values for assessment of operating railroads? At the time the foregoing question was suggested as the subject of this paper it was amplified as follows: Should commissions fix values below which they will not go regardless of security values, earnings, etc., so long as roads are operated?

In attempting to answer these questions it seems necessary to examine the legal basis for assessment of railroads and whether this basis differs from that for assessment of other property, also the methods generally used in arriving at assessments and whether the need, if any, for adopting arbitrary minimum assessments is due to method or principle. Likewise it is desirable to consider specific cases to whose treatment the question might be applied, and judge whether the same minimum figure would be fair and logical if used for all railroads. The minimum figure herein discussed refers to a given amount per mile of track or railroad, as, obviously, the question would not be appropriate with reference to the total value or assessment of railroads of materially different lengths.

As a practical matter, it seems the answer to the foregoing must be found within the limits of existing tax laws and the constitutional provisions on which they are based. An examination of a summary of tax laws of each of the forty-eight states shows the basis for ad valorem assessment of property specified as one of the following: value, actual value, cash value, market value, true value. The courts are in virtual agreement that these terms are equivalent, and that value for assessment is that which is commonly known as commercial value which may be defined as the amount that would be agreed upon by a fully informed, competent seller disposed to sell and a fully informed, competent buyer disposed to buy, neither acting under compulsion and neither being in any way under control of the other. It is true some kinds of property are entirely exempt from taxation or pay lieu taxes instead of ad valorem taxes, and there is one instance where different kinds of property are assessed at different percentages of the base, but the base is the same for all property that is assessed, and generally the same assessment ratio applies to all kinds of property. It does not appear that the laws differentiate the basis of assessment of railroads from that of other kinds of property, when railroads are assessed, nor does it appear that an arbitrary minimum is sanctioned for any type of property. Thus it seems that adoption of minimum assessments without regard to actual value is outside of the law.

Assuming it is the desire of the assessing authorities to comply not only with the letter but with the spirit of the law, which is to place all assessments on a parity either at full value or at a given percentage of value, it first is necessary to determine value. To this end one or a combination of the following methods generally is employed:

1. Conjecture
2. Comparison with sales
3. Conventionalized formulas
4. Analysis and inclusion of all relevant factors.

Valuations by conjecture are those fixed arbitrarily, usually by persons having little knowledge of the properties valued or of valuation methods, without sufficient facts, and sometimes without regard for facts that are available. The figure set by this method, if too high, provides a basis for trading with the taxpayer, which may lead to approximately correct results, and then again it may not. In the class of conjectural valuations may be included those furnished by the taxpayer that are accepted without further check. Happily, this method of valuation which is more usual in general property assessments, particularly for specialized properties, than in railroad assessments, seems to be less used than formerly. Arbitrary minimum assessments would fit into this method but would have no better basis than the method itself.

Valuation by comparison with sales is much employed, but usually for determining land values. The more complex the property, the less significance sales prices of other properties have, and even a sale of the property itself is not conclusive as to its value. So few railroads are sold that comparative sales prices alone are not much used for their valuation, and, if available, sales generally are only one of several factors considered. When comparative sales are properly used as an index of value it does not appear that arbitrary minimums are necessary or can be substantiated.

Conventionalized formulas frequently are used in valuing railroads for assessment, and less frequently for other kinds of property. These formulas usually include two or more of the following factors: capitalized net operating income averaged over a period of three, five or ten years, market value of outstanding securities averaged over some period usually the same as income, cost of reproduction of the property less physical depreciation, and possibly cost or book value. These factors may be given different weights in the formula, and their weighted average accepted as the chief indication of value, or at least as indicating relative values of different railroads. This method, if consistently used, has the advantage of preventing sharp fluctuations in assessments from year to year, and enables both the assessor and taxpayer to estimate ap-

proximately what assesment can be anticipated the following year. It also expedites the work, which is desirable when a number of assessments must be prepared within a short period after tax returns are filed. Although this method may be acceptable to both assessor and taxpayer, procedure such as this, that depends almost exclusively upon conventionalized formulas, cannot be relied upon to reflect the true or commercial value required by law. The clearest test of this is that values for commercial transactions seldom, if ever, are determined by conventionalized formulas. If, however, this method is used for assessment purposes, it sometimes happens that some of the factors are negative or are not available, and the formula yields a value that is negative or unmistakably too low. In such cases an adjunct to the formula may appear desirable, the adoption of a figure below which no value will be placed. But a minimum of this nature can be fixed only arbitrarily, therefore cannot be considered true value, and if applied uniformly to all properties cannot be expected to provide correct relative assessments.

Commercial or true value is the same whether it be used for assessment, purchase, sale, financing or any other purpose. However, this value often cannot be determined at a precise amount on which every qualified person will agree; but it can be determined within reasonable limits, the proximity of the specific figure to either limit, resting with the judgment of the evaluator after he has given consideration to all relevant factors. Probably the best approach to valuation problems is for the evaluator to imagine himself entrusted with funds for investment, or called upon in a professional capacity to advise someone contemplating sale or purchase of the property. Under these circumstances, what would he want to know about the property and how would he proceed to secure and use the information? Obviously, he first would want to know what the property consists of, where it is located, what the cost of reproduction would be, its physical condition, and its capacity for service compared to a new property of latest design. Then he would investigate the markets in which the finished products of the property could be sold, and existing and prospective competition, also the source, availability and cost of materials necessary to keep the property in operation, and the cost and attitude of labor. Likewise, he would look into the history of the property and its operating record; and, as a check upon his own judgment, would study the market prices of outstanding securities, if any, and the reasons for fluctuations in these, as reflecting appraisal by other interested parties. All of this would be done for one purpose only, to determine how much can be invested in the property with expectations of a return commensurate with the particular business hazards and the probability of preserving unimpaired or of recovering the investment. This method of valuation applies to any type of income property, whether a factory, a hotel, a department store,

an oil well or a railroad. The commercial value of a property is determined by what can be gotten out of it on and after the date of valuation, not necessarily what has been put into it nor what has been gotten out of it in the past. Commercial value is different from rate base and is dependent upon other factors.

It is the duty of assessors to determine true values, and the better this is done, the less occasion there will be for resort to conjecture, and the less reason will exist for depending upon conventionalized formulas. Therefore, when assessments are made properly, according to law and in all fairness, they will be based upon commercial values; and arbitrary minimum assessments have no place in the procedure.

For the type of railroads with which this discussion is directly concerned, those with a record of operating losses or relatively small earnings, a factor is present that tends to confuse ordinary valuation methods and makes more questionable the use of conventional minimum values. This factor which operates in the case of all railroads and in smaller but ever-increasing degree for other types of property, is restricted governmental regulation and control. A federal commission that originally was established to bring about adjustment of freight rates in proportion to the actual cost of handling different commodities, although this has not been accomplished, has, from time to time, by governmental direction and sanction, further encroached upon the normal prerogatives of ownership; and the same policy has been followed by many state commissions. Not only must every change in freight and passenger rates be approved before it can become effective, but changes in service are subject to the same restrictions. No passenger train may be discontinued nor any station closed without permission, and no railroad may be abandoned in whole or part without public hearings and governmental authorization. In other words, efficient operation and disposition of the property may be, and frequently are subordinated to political considerations. The mention of these restrictions might seem out of place in a discussion of this nature, except they have material bearing upon railroad values and usually tend to reduce these from what otherwise would obtain. Thus, even the amount that might be realized from abandoning a railroad and salvaging the material cannot be considered always a minimum value, because abandonment may be prohibited.

Typical of railroads with records of operating losses and uncertain security values, to which the question of minimum assessment might be applied, are three dissimilar cases, as follows:

A is a well-constructed trunk line which with its branches is about 1200 miles in length. The Interstate Commerce Commission's estimate of its cost of reproduction less depreciation was \$44,000,000 which, with property changes and on the basis of pres-

ent costs, now would approximate $60,000,000 or $50,000 per mile. Since the year 1932 this road has been operated by trustees in bankruptcy. Its net operating income which for 1925 was in excess of $3,500,000, declined each year until a loss of more than $300,000 was sustained in 1931. Thereafter, for four years, operating statements recorded losses or only nominal net income. The five-year average of operations at the end of the year 1934 was a loss of $6,000 per year, at the end of 1935 a loss of $120,000 per year, and at the end of 1936 a net income of $200,000 per year. Five-year averages commonly are used in conventionalized formulas. Market value of securities in the year 1928 totaled about $41,000,000, and by 1932 had declined to about $11,250,000. For the five-year period ending with 1934 security values averaged $20,000,000, ending with 1935 they averaged $14,500,000, and ending with 1936 they averaged $12,500,000. Security values, following appointment of trustees, as a rule, decline substantially from prices prior to trusteeship, although there may be no material changes in the property and earnings; and in the case of this particular railroad concentrated ownership of some important issues appeared to weaken the price of other issues more widely distributed; so security values were not a reliable indication of the value of the property. Here we have a railroad in good operating condition whose existence seems economically justified by substantial earnings in times of normal business, and notwithstanding recent operating losses and depressed security prices, appears to have considerable value as an operating property.

B is a railroad with 160 miles of well-constructed main line and 100 miles of branches. It is operated as a separate railroad by a major system that controls all of its capital stock and holds most of its outstanding debt. The Interstate Commerce Commission's estimate of cost of reproduction less depreciation was about $9,000,000, which brought to date would be about $11,500,000 or $44,000 per mile. For each of the past twelve years a net operating loss has been recorded, even during the time of highest gross revenue although this was partly due to almost complete rehabilitation of the road in part charged to maintenance. This road originates and is the terminus of considerable freight that adds to the revenues of the parent company, but its principal desirability seems to be that it controls a deep-water terminal that may afford the parent system some advantages in dealing with problems concerning its own deep-water terminal at another place. Here is a railroad that, according to its records, has little, if any, value to its present owners on the basis of operations only, but seems to protect the operations of the system, and is of value because of this.

The third railroad, C, is an illustration of the effect of government control upon values. This railroad, in poor physical and

operating condition, is 140 miles in length, including a 20-mile branch, and traverses, for the most part, good agricultural country with some natural resource deposits and other industries. The main line is crossed by ten other railroads and is paralleled by a paved highway. Originally this railroad was a division of a larger system that upon reorganization in the year 1922, abandoned operation of this line and disposed of it to a locally organized company. Cost of reproduction less depreciation was fixed by the Interstate Commerce Commission at approximately $3,300,000, an average of $24,000 per mile. The net result of operations has been a steadily increasing deficit, and for six years the road has been operated by a receiver. Inability of the new company to operate the railroad at a profit caused the management, after four years, to petition the Interstate Commerce Commission to require a large system to purchase and operate the railroad. This the commission did, making the acquisition of this road a prerequisite to approval of other matters sought by the system, and ordered that the purchase be made at the commercial value of the property.

This action caused a thorough engineering examination of the construction, condition, business and potentialities of the railroad, for the purpose of determining its commercial value. The examination occurred during the period 1928 to 1930 when railroads together with other business were in better condition than at any time since. It was found the highest utility and therefore the greatest value of the line, lay in breaking it up, abandoning and scrapping much of it and attaching the remaining sections to the various railroads that crossed it. If such procedure could have been carried out, a value of more than $1,000,000 at the time, was indicated. It also was quite evident that the ownership of this road would be a liability rather than an asset to the system that was ordered to purchase it, because no increase in business could be expected and the operating costs would be greater than those of a smaller company. The commission stated in its order that the preservation of the lines of this railroad was required by public convenience and necessity and that while the commission gave consideration to the contention that operating costs to the system would be higher, still it was persuaded the railroad was apparently incapable of successful independent operation, that the interests of the people of an important agricultural section require that the service performed by the lines be preserved, if possible, and that the flow of traffic indicated the lines are a natural and logical adjunct to the system.

A board of arbitration found a commercial value of about $360,000 for the railroad. The commission ordered the system to acquire the property at a commercial value of $230,000, but postponed the purchase until the system had funds available. Later the price

was reduced by the commission to $165,000, and more recently to $110,000, but still funds are not available.

Here is a railroad in operation, that might have had substantial value had its owners been able to dispose of it according to its greatest commercial utility, but through governmental control has had its value to its present owners reduced to a rather insignificant amount; and when the transfer is made as ordered, the road not only will have no value to its new owner but will be a liability. Is it unreasonable to suggest that a railroad required to be kept in operation on the grounds of public convenience and necessity and whose operation can result only in loss to its owners, be valued at zero and assessed accordingly?

It is evident that no one amount per mile could be adopted to represent equitably a minimum value for each of the aforesaid three railroads nor for any two of them. Nor does it seem practicable in these cases to develop a conventional formula applicable to any one of the railroads. Each railroad presents an individual problem to be studied and acted upon separately, and the commercial value which is the basis of assessment can be determined in no other manner.

One reason that might be urged for placing an irreducible minimum value upon operating railroads, particularly in states where railroad assessments are allocated to separate taxing districts, is that most districts have developed schemes of expenditures that depend for funds to greater or less degree, upon taxes paid by railroads and reduction in railroad assessments adversely affects the finances of these districts. However, it frequently occurs that a large industry, sometimes even a railroad, is removed from a district, and when property ceases to exist it cannot be taxed. In like manner, when values cease to exist they should not be assessed and taxed even if the property that once had value is still in place. Need of revenue is no valid reason for taxing values that have vanished.

The conclusions reached after considering whether commissions should fix values for railroads, below which they will not go regardless of security values, earnings, etc., so long as roads are operated, are that there appears no justification for this in the law, that there is no means of determining a minimum figure that would be equitable for all railroads, and further, there is no need of using a conventional minimum amount if the commercial value of the railroad is determined as required by law.

Presiding Officer: Well, I congratulate you, Mr. Wallace, on the consolation that you have presented to some of my customers. The approval that they gave as you have proceeded is eloquent testimony to their appreciation of your consideration of this problem.

Now, the next topic on the program is one that the first speaker raised and one which followed somewhat the remarks of the second speaker, that unit valuation, in large part, is a controversy between the states without the benefit of any referees and, for the most part, without many rules. The next speaker, while he will not be called upon to classify New Jersey—although he might do that impartially, let me say that—will address his attention to the terminal states versus the bridge states. That is a topic that has interested Mr. McCrary very much, one on which he has done no little work. It gives me great pleasure to present Mr. E. A. McCrary, the tax commissioner of the Northern Pacific Railroad.

THE TERMINAL VERSUS THE BRIDGE STATES IN THE ALLOCATION OF UNIT VALUES

E. A. MCCRARY

Tax Commissioner,
Northern Pacific Railway Company

Railroads are taxed on an ad-valorem basis in most of the states and it is therefore necessary to find the value of the property subject to taxation in each state. This is a difficult undertaking in the case of interstate railroads. Originally, it was thought that the physical property in each state or subdivision could be separately valued without reference to its relation to the whole system of which it was a part. It is manifest, however, and is now universally conceded—on account of New Jersey I will have to say almost universally conceded—that piecemeal assessments of railroad property are not feasible; that the real value of a part of a railroad system comes from the fact that it is part of a system; and that the usual practice is to value the entire operating plant of each railroad as a unit.

The value sought for taxation purposes is market value and the unit value is therefore the market value of the railroad system as a going concern including its franchises and all property used for railroad purposes. Commonly used methods of finding the unit or system value of a railroad are the stock and bond method, the capitalization of net earnings method, or a combination of both methods. These methods have been approved by the courts and are favored by assessing officers but the values produced by them are strictly unit values, in the sense that they include all intangible values. If a railroad operates in more than one state, it becomes necessary to devise some method for dividing this unit value among the several states.

It must be borne in mind that an interstate railroad is valued as a unit only because it is impossible to value separately as a going unit the portion in each state. That portion of a railroad in any

state must be valued as an integral part of an operated system and state assessing officers are permitted to look beyond the borders of their own state only for the purpose of determining the value of the property actually within that state. An equitable allocation must assign to each state that portion of the unit value fairly represented by the property within its own borders.

The character of an interstate railroad's property is seldom the same in any two states. The location of extensive terminals clearly indicates which states may be described as "terminal states." A real "bridge state" would be one in which no traffic is originated or terminated but which is crossed by a railroad line serving productive territory on either side. Actually the bridge state usually originates and terminates some traffic, but such traffic is less in volume than the bridge traffic. The conflicting claims of the terminal and bridge states become apparent in the selection of methods for allocating unit values and may be brought out by the consideration of the various allocation factors which are commonly used. These are:

1. All track mileage.
2. Cost of reproduction.
3. Car and locomotive miles.
4. Ton and passenger miles.
5. Gross earnings.

The first two factors (all track mileage and cost of reproduction) may be termed property factors because they indicate only the distribution of physical properties; the last three factors may be termed use factors because they indicate the extent to which the property in each state is used, and reveal nothing as to the quantity or extent of physical property in each state.

The all-track mileage factor distributes unit value according to the miles of track in each state as compared to the total of the system and every mile of track is given equal weight in computing percentage of system value to be assigned to each state.

The terminal states contend that this factor does not reflect relative values because it ignores the differences in the costs and values of the different parts of the track mileage. They point out that it spreads out over the system, the value of terminal facilities such as depots, docks, shops, yards, warehouses, etc., located in one state. Because of the high cost and indispensable character of these additional facilities and the higher land values found in the terminals, they insist that a mile in the terminal represents as much plant as several miles in the bridge states. In support of these contentions, the following from *Fargo* v. *Hart*, 193 U. S. 490 is cited:

"But it is recognized in the cases that if, for instance, a railroad company had terminals in one state equal in value to

all the rest of the line through another, the latter state could not make use of the unity of the road to equalize the value of every mile."

The bridge states reply that the terminal states are confusing cost with value. That a mile of track in a bridge state is just as essential and valuable as a mile in a terminal state. Perhaps more essential because the removal of one mile in the bridge state stops all traffic while there is a strong suspicion that some terminals have been overbuilt and contain more plant than is needed, if terminal operations were properly consolidated and coordinated. They point out that the value of large terminals results from the fact that they are part of a large railroad system and does not inhere in the terminals as such. Therefore, that the terminals enhance the value of every mile of railroad on the system and that the portion of the railroad in each state should be valued as a component part of the system and not as a separate and disconnected piece of railroad. They regard the excessive cost of construction and operation of terminals as a necessary burden, but as to value refer to the following quotation from *Cincinnati Southern Railway* v. *Guenther* (c.c.), 19 Fed. 395:

> "A railroad that costs $20,000 per mile is worth as much as one that costs $50,000 per mile, if its business and net earnings be as great or greater. Indeed, it is more valuable, in one sense, as it makes a better return on the investment."

If miles of all tracks operated instead of all tracks owned and operated be used, an additional objection to the all-track mileage factor is that it gives equal weight to a mile of track over which the operating company has only trackage rights. This objection may be offered by either a bridge or terminal state, as the advantage may lie either way.

In spite of all objections, use of the all-track mileage factor in connection with other factors has not been disapproved by the courts and probably its use will be continued.

Use of the physical property factor as represented by cost of reproduction results in an apportionment based upon the relative character and quantity of property in each state. Units of property are measured in dollars, the only common denominator. This factor, of course, ignores the relative use made of the properties.

This factor is generally favored by terminal states and is sometimes claimed to be the only one of the five factors under consideration which gives to a terminal state its fair proportion of the system value. Attention is called to the high land values prevailing in terminal cities and to the costly shops, docks, depots, etc., found in the terminals.

Since the physical property factor is based upon cost, the bridge states quote the supreme court of the United States as saying in *Cleveland, C. C. & St. L. Ry. Co.* v. *Backus*, 154 U. S. 439:

> "Will it be said that the taxation must be based simply upon the cost, when never was it held that the cost of a thing is the test of its value?"

or in *W. U. Tel. Co.* v. *Taggart*, 163 U. S. 1,

> "The cost of the property, or of its replacement, is by no means a true measure of its value."

They assert that since original cost or cost of reproduction do not in any way reflect present value, such cost figures do not afford a reliable basis for apportionment of value. Again, they refer to their contention that terminal facilities are more extensive than needed and probably would not be reproduced as now existing. They may also claim that the physical property factor is especially unreliable as to terminal values because it is based upon I. C. C. appraisals made some twenty years ago, at a time when land occupied by railroad terminals was generally considered to be very valuable. Since then the development of motor transportation and changes in methods of handling both freight and passengers have brought about such a shifting of land values in many terminal cities that land thought most valuable twenty years ago is now being sold for taxes.

The car and locomotive mileage factor in some degree shows distribution of equipment and is a property factor to that extent. It reflects relative use of the fixed property and so may be considered as a combination property and use factor.

This factor is objected to by the terminal states because it is a line haul factor and takes no account of movements of equipment (other than locomotives) in the terminals. Since use of the terminal facilities is not reflected, it is argued that the terminal states get no credit at all for terminal values. The factor is also objected to on the general grounds that no distinction is made as to the value or size of equipment or as to whether cars are loaded or empty.

The car and locomotive mileage factor is defended by bridge states as one that accurately shows distribution of equipment, a fairly large element of railroad value, and reflects use of the fixed property. Increasing density of traffic as it nears the terminals is claimed to give the terminal states a fair break in apportionment. Relative use of property is assumed to indicate its relative proportion of system value. Kind of cars used, they say, is immaterial in computing relative use and the movement of an empty car or one containing company material is just as essential to the operation of the plant as any other service.

The ton and passenger miles factor allocates according to units of traffic. Transportation of a ton of freight or a passenger for one mile being a traffic unit.

Allocation on the basis of traffic units in each state is not liked at all by the terminal states. They insist that their valuable terminals are completely ignored because the ton and passenger miles are based on station-to-station movements and do not reflect any use of terminal facilities. They object further on the grounds that it is absurd to assume that all traffic is of equal value from a transportation standpoint.

The bridge states argue that values vary with the traffic density and that the concentration of traffic in the terminal states provides a due allowance for the terminals. The criticism on account of diversity of traffic is answered by saying that character of traffic handled in the terminal states must necessarily be the same as that transported across the bridge states.

The gross earnings factor is computed by adding to the total intrastate earnings in each state a mileage prorate of the interstate revenues. The factor assigns to each state a proportion of system value equivalent to the proportion of the system operating revenues earned in the state.

The gross earnings factor is not regarded with favor in the terminal states because of the mileage prorate of interstate revenues. It is claimed that the total charge for passengers or freight traffic must include something for terminal services and that the mileage prorate assigns too little revenue to the terminal state and too much to the bridge states, and therefore assigns too little value to the terminal states.

The gross earnings factor is defended by the bridge states on the grounds that value depends upon earnings and that a state's contribution to the total earnings of the system is a fair measure of its share of the total value of the system. The bridge states conclude their arguments in support of the gross earnings and other use factors by quoting the supreme court of the United States in the Backus case—154 U. S. 439—as saying:

> "The value of the property results from the use to which it is put and varies with the profitableness of that use, present and prospective, actual and anticipated. There is no pecuniary value outside of that which results from such use."

The five factors heretofore discussed are substantially the same as those recommended to the National Tax Conference of 1923 by a special committee on the taxation of public utilities. All of these factors seem to be objectionable to the terminal states except the physical property or cost of reproduction factor, and perhaps some attention should be given to efforts that have been made to devise

a method of apportionment that would be acceptable to terminal states.

In *Census Bulletin No. 21,* issued in 1904, Professor B. H. Meyer suggested that relative net earnings would be the most defensible basis for the apportionment of system values of interstate railroads, if it were possible to determine net earnings by states. He concluded, however, that the difficulties involved in the localization of both revenues and expenses made the net earnings method impracticable. In 1933, the Great Northern Railway Company brought a suit in North Dakota in which it devised a method of computing net earnings within the state and claimed that system value should be apportioned on a net earnings basis. Since the method proposed would have greatly reduced the proportion of system value allocable to North Dakota and other bridge states, the railway company appeared as a champion of the terminal states and the controversy between bridge and terminal states was submitted to the federal courts. The final decision was by the United States Supreme Court on February 3, 1936, and is reported in 297 U. S. 135.

The court found that the state had used as allocation factors the percentage in the state of total track mileage; of physical property, measured by cost of reproduction less depreciation; of car and locomotive miles; of ton and passenger miles; and of gross earnings. It was held that

> "Having regard to the size of the entire railway system and the variety of things that affect values to be attributed to its railroad in different states, and the numerous matters as to which there may be wide difference of opinion, the use of the percentage was not shown to be confiscatory or arbitrary."

The court referred to its decision in *Rowley* v. *Chicago & Northwestern Railway Company*, 293 U. S. 102, wherein the use of track mileage when combined with other factors had been upheld, and made this general statement:

> "The problem of apportionment is a difficult one. It is impossible to formulate a rule generally applicable. Controlling conditions vary greatly from time to time. Allocations to be sufficiently accurate for practical purposes must be arrived at by the exercise of sound judgment based on facts that fairly *reflect* the relation between value of the system as a whole and value of the part within a state."

The court rejected the Great Northern's proposals that system value be apportioned on the basis of relative net earnings or on the basis of relative cost of reproduction, and to that extent sided with the bridge states.

The use of five factors in allocating a unit value is sometimes criticized on the grounds that each factor is defective in some respects. Admitting that to be true, I contend that the defects are magnified by using fewer factors and minimized by taking an average of five factors. The defects of each factor which make it indefensible when standing alone are overcome by the good qualities of the other factors.

The Northern Pacific Railway Company, which I represent, is operated in seven states and the Province of Manitoba. We have no reason for increasing or decreasing the allocation to any state but we have only one system value to be apportioned and naturally desire to have that unit value allocated so that the sum of the parts will not be greater than the whole. We suggest that each state use an average of the five factors previously referred to but if each of the eight taxing units were to select the factor most favorable to it, 119.86% of our system value might be subjected to taxation. The excess of 19.86% applied to a system value of $200,000,000 would result in the double taxation of $39,720,000 in value.

In conclusion, may I say that I have endeavored to present to you both sides of the argument without being partial to either terminal or bridge states. I hope that continued study of the subject of allocation will enable them to compromise their differences of opinion.

Presiding Officer: We have heard from tax commissioners and railroads; now it is time to hear some impartial opinions as to the methods that the two parties either use or advocate. The next speaker is Professor M. M. Daugherty of the University of Delaware, who is going to tell us what he thinks about some of the alleged methods which supposedly are followed.

A STUDY OF THE METHODS OF ASSESSING RAILWAY PROPERTY FOR TAX PURPOSES

M. M. DAUGHERTY
Economist, University of Delaware

The old adage, "We never miss the water 'til the well goes dry," can surely be applied to the subject of railway taxes. If the topics discussed in these conferences are reliable indices of the members' interest in the subject discussed, and I believe that they are, this subject must have been quiescent for a long time, for from 1912 to 1936 there was only one major paper scheduled on railway taxes. It was given in 1919 on the subject "State Taxation of Railroads under Government Ownership or Operation." On the other hand, from 1907 to 1912 the subject was treated separately several times, and it has been incidentally the subject of discussion

in several papers concerning public utility taxes, particularly in the early 1920's. But until the depression came, it was impossible to get either the taxpayers or the tax administrators to take any sustained interest in the subject. The railways considered taxes as a necessary but minor evil about which they could do little or nothing. On the opposite side the taxing authorities considered the railways as rich but reluctant taxpayers. The situation is now changed, and apparently changed for the worse, and what is more, permanently changed. The "well", if not dry, has such a small amount of water that the bucket is scraping the bottom and coming up but half full.

TABLE 1

Relation Between Net Railway Operating Income (before taxes) and Total Tax Accruals 1910–1936 * (000,000 omitted)

	Net Railway operating income before taxes	Tax Accruals		Net Railway operating income before taxes	Tax Accruals
1910	$ 903	$ 98	1924	$1,331	$ 347
1911	848	103	1925	1,503	366
1912	841	114	1926	1,626	397
1913	727	122	1927	1,461	383
1914	814	140	1928	1,578	396
1915	832	138	1929	1,665	403
1916	1,153	150	1930	1,228	354
1917	1,170	219	1931	836	308
1918	876	230	1932	604	279
1919	693	239	1933	731	254
1920	301	289	1934	710	244
1921	884	283	1935	746	241
1922	1,077	308	1936	1,001	325
1923	1,315	340			

* Statement 53, *Statistics of Railways in the United States*, 1936. Interstate Commerce Commission, Washington, D. C.

Amount of Taxes Paid, 1910–1936

Perhaps a few historical statistics will be useful to show the extent to which the situation has changed. Table 1 is an attempt to show the relationship between net railway operating income and the taxes paid by the railways. I have chosen these particular figures because one comes closer to grips with the situation of the relation between the income and the tax-paying ability of the lines by getting away from financial structure.

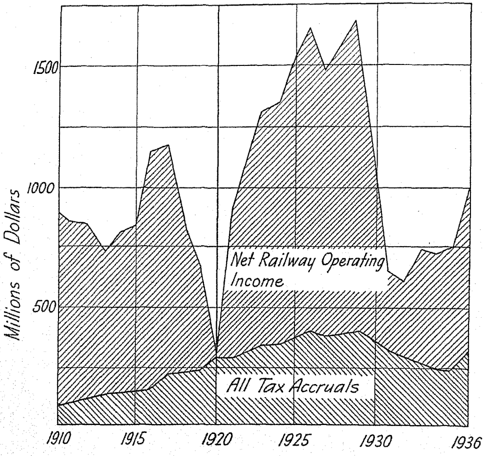
An examination of Table 1 reveals in general the plight that the railways are in, although since it stops at 1936 it does not show their very bad position of today. The situation now is much more

like that of 1932 than like that of 1936. In the five years from 1910 to 1914 the railways received an average net railway operating income of $827,000,000 before taxes, out of which they paid an average of $115,000,000 in taxes, i.e. 13.96%. The five years from 1923 to 1927 they received an average net railway operating income (before taxes) of $1,447,000,000, out of which they paid a tax bill of $367,000,000, or 25.33% of their net railway operating income. In the last five years, 1932 to 1936, they received an average of $758,000,000, of which $269,000,000, or 35.42%, was paid out on the same basis.

The information in Table 1 is graphically presented in Figure 1.

FIGURE 1

Relation Between Net Railway Operating Income (before taxes) and Total Tax Accruals 1910–1936



Comparison between Amounts of Taxes Paid by Railways and Farms

These figures do not answer the question whether or not the railways are over- or under-taxed, nor whether they are taxed more than anyone else. But since many look at taxes as a matter of

relativity, both in terms of time and kinds of property, it might be pertinent to compare the taxes upon railways with the taxes upon farm real estate from 1910 to date. This comparison can be made by reducing the total tax bill of both classes of property to index numbers, using the period of 1910 to 1914 as a base. The farm tax data used are those published by the department of agriculture and represent the total taxes paid on farm real estate.[1] The comparison is made in Table 2. Figure 2 illustrates Table 2.

TABLE 2

COMPARISON BETWEEN TOTAL RAILWAY TAX ACCRUALS AND TOTAL TAXES PAID ON FARM REAL ESTATE, 1910–1936 (000,000 omitted)

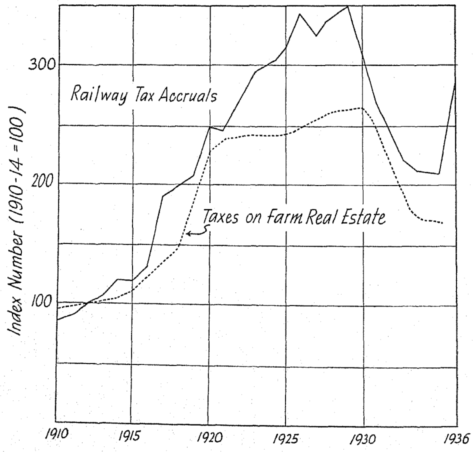
	Total tax accruals	Index number 1910–14 =	Farm real estate tax	Index number 1910–14 = 100
1910	$ 98	85	$204	96
1911	103	89	210	98
1912	114	99	212	99
1913	122	106	218	102
1914	140	121	222	104
1915	138	120	243	114
1916	150	130	260	122
1917	219	190	292	137
1918	230	199	311	146
1919	239	207	393	184
1920	289	250	483	227
1921	283	245	510	239
1922	308	267	509	239
1923	340	295	516	242
1924	347	301	511	240
1925	366	317	517	242
1926	397	344	526	247
1927	383	332	545	256
1928	396	343	556	261
1929	403	349	567	266
1930	354	307	566	265
1931	308	267	519	243
1932	279	242	450	211
1933	254	220	385	181
1934	244	211	366	172
1935	241	209	365	171
1936	325	282		

[1] *Agricultural Statistics*, 1937, p. 386, U. S. Department of Agriculture, 1937.

Table 2 indicates that, taking 1910 to 1914 as the base period, railways have had their taxes increased much faster than have the farmers. Not only did railway taxes rise earlier and faster, but they rose farther. Nor have they come down as quickly nor as far as have the taxes on farm real estate. If the comparison of these two index numbers is equitable for the base period, then it appears that the railways have been very badly treated for the last couple of decades.[2] But there is an "if" in the above statement, and let me say that that "if" is large.

FIGURE 2

COMPARISON BETWEEN TOTAL RAILWAY TAX ACCRUALS AND TOTAL TAXES PAID ON FARM REAL ESTATE, 1910–1936



However interesting the historical comparisons may be, I do not think they show much from the standpoint of equity, nor do I think that Table 1 alone proves that the railways are now over-taxed.[3] On an *a priori* basis, it is equally justifiable to say that the railways

[2] Of course an important element of equity over this time period rests on the comparative expansion of the two industries. In view of what follows, it is not necessary to inquire into relative expansions.

[3] Although the presumption is strong, for we have a way of growing accustomed to a given rate of tax.

were "getting away with murder" in the periods from 1910 to 1914 and from 1923 to 1927 as it is to say that they were being "murdered" from 1932 to 1936. The question of "murder" is a question of equitableness of the tax as levied, not from any comparisons, historical or categorical (by earnings, as is done in Table 1, or by comparisons of different entities, as is done in Table 2), for these comparisons depend for their validity upon the assumptions that at some time past the taxes levied were equitable. And there is no proof that they were. Accordingly the equitableness of the tax must be approached by a different route. Since taxes are a matter of valuation and rate, an approach can be made to the problem by ascertaining what kinds of taxes the railways pay and examining each kind of tax, in turn, for its equitableness.

Kind of Taxes, by Jurisdiction, 1934

In 1935 the Association of American Railways gathered data from all railways in the United States in regard to the amounts and kinds of taxes paid by its members. A summary of the payments to all state and local governments for the year 1934, subsorted by jurisdictions and kinds of taxes, is presented in Table 3.

TABLE 3

Amounts and Kinds of Taxes Levied on Railways, by State and Local Governments by Jurisdictions, 1934

(In thousands)

Taxing jurisdiction	Ad valorem levies	All other taxes	Total	Percent ad valorem is of grand total
County	$ 32,604	$ 161	$ 32,765	14.43
Township	1,539	2	1,541	.68
Municipality	23,304	402	23,706	10.31
School District	27,783	174	27,957	12.30
Road and Bridge	6,688	4	6,692	2.96
All other jurisdictions	50,527	164	50,691	22.36
Total local taxes	$142,445	$ 907	$143,352	63.04
State Taxes				
Commutation		$ 111	$ 111	
Franchise		8,198	8,198	
General property	$ 53,100		53,100	23.50
Gross Receipts		3,852	3,852	
Licenses		14,600	14,600	
Rolling stock		701	701	
All other		2,051	2,051	
Total State	$ 53,100	$29,513	$ 82,613	23.50
Grand Total	$195,545	$30,420	$225,965	86.54

In 1932, the last year for which we have the figures, about 2.5% of all state and local taxes were paid by the railways. Out of the $226,000,000 state and local taxes accruing from the railways in 1934, $195,545,000, or 86.54%, was levied as ad valorem, and since many of the licenses and franchise taxes were levied in lieu of ad valorem taxes, I think it is safe to say that at least 90% of all state and local taxes accruing from the railways in 1934 were general property levies made by the state and local governments. The same generalization holds today. The crux of the equitableness of the railway tax burden then is the ad valorem tax.[4]

The State and Local Ad Valorem Tax

The practical results of this tax come from both the valuation and the rate, but in this discussion I shall confine myself to the subject of valuation of railway property, because I believe the proper approach to the subject of equity is through that field. Accordingly, I shall first discuss railway valuation for purposes of local taxation, then I shall discuss it for state tax purposes, dividing the states into two groups, those which do not use the "unit" or system value and those which do use that method of arriving at railway value for tax purposes.

Measures of Value Used by Local Assessors

In some thirty-five states local assessors value railway property for tax purposes. By means of a questionnaire I have received information from local people in regard to the indicators of value used in seventeen of the states in arriving at the taxable value of the various railway properties falling within their jurisdictions. According to my information, these local assessors use only two measures of value: cost of reproduction less depreciation, and sale value. Table 4 indicates the several kinds of property taxes and the indices of value used for each kind of property.

TABLE 4

Indices of Value Used by Local Assessors in Arriving at Values of Railway Property

Kind of property	No. of times reproduction cost used	No. of times sale value used in valuation
Personal property only	2	1
All operating property	2	2
All non-operating property	3	13
Real estate		9

[4] Some dozens of other levies are imposed on the carriers; many are great nuisances and require much accounting for a small amount of money.

I think it is safe to say, except for non-operating real estate, that the great majority of local assessors arrive at value by the route of reproduction cost less depreciation. They could not arrive at it in any other way. Stocks, bond values, earning capacity, etc. are not considered by local assessors, and railways have no piecemeal sale value. Then how do they arrive at reproduction values? Usually by one of two methods. The railway tax agent submits a list of property owned within the jurisdiction, together with his idea of taxable values, or the local assessors themselves assess the property. If the local assessor does not have the services of a trained valuation engineer, and most of them do not, his valuation is nothing more or less than a guess. If he has such services, the values arrived at much more nearly approach the mark of reproduction cost less depreciation.

Sometimes these assessments are remarkably consistent, sometimes they vary markedly. Through the kindness of a friend who is a railway tax commissioner for a large company, I have been able to obtain the assessed values per mile of all track of a railway which we can call the A, B & C. Railway Company. To test the average amount of variation in valuation, we selected only political areas in which there were no unusual structures of any kind. The list below shows the average assessed value per mile of all track before equalization for each of the political entities involved.

$15,500	$17,200	$22,200
15,700	19,400	22,500
16,500	20,100	23,000
16,800	21,250	24,000
17,100	22,000	43,000

The variation in this case is no greater than among the states using the unit method.

It is common knowledge that very little use is made of the figures of the Bureau of Valuation of the Interstate Commerce Commission by local tax assessors except when they are engaged in litigation. Not one of the seventeen people who answered the questionnaire in regard to local assessment said that the local assessors used Interstate Commerce Commission figures. These cost of production less depreciation figures can be obtained very cheaply from the Interstate Commerce Commission. It seems to me that there is plenty of room for difference of opinion upon the propriety of using cost of reproduction less depreciation as an indicator of railway value; but once that criterion has been selected, I see no excuse for not using the estimates of the Interstate Commerce Commission.

State System of Valuation

A. *Non-unit Value States*

By the same process of questionnaire, I received information from nine states which have central assessing bodies but which do not use the unit method of valuation. Of these nine states, it was the duty of five to value all the property of the railways. Of these five states, three used reproduction cost less depreciation as one indicator of value, one used reproduction costs and past net earnings, and one used reproduction cost and "sale value." Four states valued non-operating property alone on a sale value basis. Tangible personal property was valued by three states on a basis of cost less depreciation.

There is much uniformity in the method of valuation used by the non-unit states. However, I do not mean to imply that I consider uniformity an indication of correctness. There are many among you who will say that the uniformity of the five states which use reproduction cost less depreciation in assessing the value of all property, only proves that these five are all equally wrong.

B. *States Using Unit or System Valuation*

To ascertain the various ways that railroads are valued by "unit" states, I sent a questionnaire to the various state tax commissioners of the states using the unit method. I asked them what criteria of value they used in arriving at system value, and the weights they

TABLE 5

Frequency of Use of Measures of Value of Railway Systems by State Assessment Bodies

	Times used	Percent of times used
Group 1—Cost, less depreciation—A. Original	8	36
B. Reproduction	15	68
Group 2—Value of stocks and bonds		
A. Present year values	8	36
B. Average of 5-year values	11	50
Group 3—Net earnings		
A. Last year	4	18
B. 3-year average	1	5
C. 5-year average	17	77
Group 4—Gross earnings		
A. Last year	6	27
B. 5-year average	8	36
Group 5—Prospective earnings	9	41
Group 6—Number of states using other factors ...	11	50

assigned to these criteria. I received replies from twenty-two of these states by the time it was necessary to prepare this paper. I wish to thank them for their kind cooperation. These twenty-two states used five major and several minor measures of value to arrive at system valuation. The factors used and the frequency of their use are indicated in Table 5.

The five groups of indicators of value are in effect only three, for net earnings, value of stocks and bonds, and prospective earnings are, to a high degree, duplicates of each other.

Some states used factors which more or less duplicated each other. For instance, of the eight states using original cost less depreciation as a factor, seven used it in connection with reproduction cost less depreciation. Of the eight states using present stock and bond values, three also used prospective earnings. Eleven of the seventeen states using a five-year average of net earnings, also used a five-year average price of stocks and bonds. When two factors which markedly influence each other are used, their joint effect is simply a weighting of the one factor.

I shall not attempt to discuss which of these factors are "right" or which are "wrong," but I shall content myself with pointing out that they give different results. It seems to me that if two different tax commissions value the same system at approximately the same time and they get markedly different values before equalization, then one is wrong. And they do get very markedly different values.

Only six states gave me the formulae which they used in unit valuation. Two states used the same scheme, and in two the scheme was not sufficiently definite for me to risk applying it.

To test the divergence in the results caused by the application of the three remaining distinct formulae, I have taken an actual line about which all the pertinent data are available. For our purposes, let us call it the A, B & C Railway Company. The average selling price of its stocks and bonds over the last five years has been $15,000,000. Net railway operating income has averaged $126,000 over the same period. Its average gross receipts were $13,500,000 over that period. Its book value is $43,000,000, and according to the Bureau of Valuation of the Interstate Commerce Commission, its replacement value less depreciation is $55,000,000.

Had the A, B & C Railway been valued according to the system valuation formula of state X, its valuation before equalization would be $9,350,000, according to state Y it would be $15,000,000, according to state Z it would be $27,500,000. Its actual assessed value before equalization is $37,000,000.

Of course, it may be said that this is a hypothetical case and in actual practice such divergence would not occur. To test the actual variations, I asked the tax commissioners of several railways to

furnish me with system valuations for each of the several states in which they are assessed by the unit method. Only three had the necessary data from each of three states during the last tax year. These systems, together with their valuations, are shown in Table 6.

TABLE 6

VARIATION IN ASSESSED VALUE OF DIFFERENT RAILWAY SYSTEMS

System	State 1	State 2	Percent of State 1	State 3	Percent of State 1
A	$391,247,000	$424,155,000	108.4	$524,709,000	134.1
B	194,000,000	304,000,000	156.7	321,000,000	165.4
C	158,070,000	278,025,000	175.9	305,362,000	193.2

The differences in the valuations of System "A" are not very great for the variation between the highest and the lowest is only about a third; nevertheless they are sufficiently large to make a difference of $1,334,620 in taxes at the rate of 1% of assessed value. It is not surprising that the variations in the value of System "C" are almost 100% when one considers the very different criteria of value in use, and the very different weights which it is possible to assign to them.

Now, it seems to me that when you and I look at this table here and I say the thing is forty feet long and you say it is only twelve feet long and somebody else says "Tut, tut, that couldn't be more than six feet long," we need to figure out who is right and who is wrong on this thing. When we are valuing the same thing at the same time it looks to me like somebody is wrong—I am not saying who.

CONCLUSION

What is value as applied to railway property for purposes of taxation? A very illusive concept, else tax assessors would not stalk it with such stealth. Or it must be a very complicated concept, only approachable indirectly. Tax assessors do not use devious paths because of preference, but because railways have peculiarities of value not found among the great majority of the properties that the assessors are called upon to value.

We have now been taxing the railways for over a hundred years, and it seems to me from having studied the history of railway taxes and the history development of state and local tax systems that the taxation of railways in practice and law, like Topsy, "just growed." But in some states it has "growed" to a very much more perfect stature than in others. I am surprised at how little constructive research work has been done on this important subject. Many articles have been written on how railways should not be taxed,

some on how they are taxed, but few on how they should be taxed. And most of the last are biased. I do not believe that we can expect to make any great progress in the proper consideration of railway taxation so long as we consider it to be merely a part of general public utility taxation. Railways have certain economic peculiarities which distinguish them markedly from other public service corporations. These may at bottom be only differences in degree, but they in practice are of such magnitude as to become almost differences in principle.

In this National Tax Association there lies a great opportunity for a constructive contribution. In this organization we have four groups of people whose knowledge combined can work out an answer to the question of how the railways should be taxed. These four groups are: first, the railway tax officials, who are specifically qualified to speak about the factors which contribute to the value of railways, and who are in touch with the costs of tax accounting; second, the public tax officials who are especially qualified to discuss the difficulties of assessing and collecting the various railway taxes; and third, the professoriate who are familiar with general tax theories; and fourth, the legal profession who are familiar with the legal pitfalls of taxation. I propose, therefore, as a first step toward the ending of this confusion that the president of this organization appoint a committee to study the methods employed in the assessment of interstate railways, and recommend improvements to the conference next year. I have introduced such a resolution. I see no reason why the various members of this conference cannot pool their knowledge and talents to make a real contribution to the science and practice of taxation.

Presiding Officer: The only thing wrong about Mr. Daugherty's paper is he didn't tell us who 1, 2, 3 were and A, B, C. If we could get him to work on a rating system in which he would value the railroad and then rate the state's performance and assigning ratings from one to forty-eight, we would at least have some of the raw data which this committee might use for their report.

The next speaker has complete freedom of the field. He has written a paper which he may or may not deliver. He is qualified both on the theory and the practice and out of the depth of long experience and straight thinking, to talk about any of the topics on the agenda. We have all admired him much, as he has worked among us for many years, and we have had the highest esteem for his work as a practitioner and representative of the railroads. I learned much at his feet as a youngster, when I was first trying to teach — a debt which I like to acknowledge. It gives me great pleasure to present my good friend George G. Tunell, tax commissioner of the Santa Fe Railroad.

MR. TUNELL: I wish I had something worthy to say of the introduction that has been given to me. There is such a thing as damning people by faint praise and there is such a thing as damning people by excessive praise. I think the latter method of damnation is the most complete.

My statement is going to be very brief; the time is getting late. What I shall have to say I hope will be of a very practical nature. It was more or less accidental that I chose as a subject for discussion "Use versus Ownership as a Basis for Taxation."

USE VS. OWNERSHIP AS A BASIS FOR TAXATION

GEORGE G. TUNELL

Tax Commissioner, Santa Fe Railroad

One of the topics set for discussion at this round table is worded—"Use vs. Ownership as a Basis for Taxation." As "Railroad Tax Problems" are the problems announced for consideration, I suppose we are to discuss "Use vs. Ownership as a Basis for Taxation" in the forms in which this problem is found in the railroad tax field. So far I feel that I am on secure ground of verbal statement but am aware that no clear concrete problem has appeared for discussion. As use implies something used and a user, and as ownership implies something owned and an owner, I supposed it may be inferred that we are here to discuss the question as to whether things should be taxed against the user or against the owner. The words "use" and "ownership" are abstract terms and for the purposes of the general property tax must be given pecuniary expression.

Of course where the user and the owner are identical no problem appears. The problem does arise where use of property is shared by the owner with another and where the user and the owner are separate and distinct entities. We thus have for discussion facilities that are owned by one railroad but whose use is shared with another, also where a railroad in its entirety or railroad facilities are leased to another railroad, cars used but owned by private car companies and cars used but owned by other railway companies, that is, foreign line cars.

The problem of the taxation of property where use and ownership are divorced will be discussed, and will be discussed in its practical aspects. A railroad for purpose of taxation is regarded as a unit and two methods of valuation for assessment are in general use with no substantial reliance upon any other approach where the railroad is a going concern. Perhaps that statement is a little broad—that assumption. I shall consider the valuation and assessment for taxation of the property we have under consideration from the standpoint of the value of use found by the capitalization of the net income methods of valuation. Our problem, probably in its simplest

form, is presented where one railroad under a lease "uses" the property of another. This arrangement will be discussed first. Our first concern will be to discover the make-up of the net railway operating income the sum to be capitalized for valuation and assessment. The accounting rules of the Interstate Commerce Commission direct that the properties for accounting purposes shall be treated as a unit. The rent paid for the use of the leased property is not treated as a joint facility rent and thus is not a charge which has reduced the net railway operating income. Under the accounting rules of the Interstate Commerce Commission rent is treated the same as interest and thus is taken out after the net railway operating income is found. From this it is seen that the net railway operating income is available for capitalization to obtain the value of the combined owned and used (leased) property and if desired the rent is available for capitalization to obtain the value of the leased property and the net railway operating income of the combined properties less the rent paid for leased property is available to obtain the value of the owned property. So there is no difficulty there in the application of the capitalization of the net income method.

What should be the valuation procedure? It would seem that the combined properties should be treated as a unit provided there is validity in the unit idea of railway systems but there may be a conflict of interests. The rental fixed by the lease for the used property may be higher or lower than present day earnings justify, and if this owned property is in one state and the property in leases is in another state there will be a conflict of interests with the state having the legal advantage probably unwilling to forego it. That conclusion has been strengthened by what I have heard this afternoon.

The problem of the terminal companies will next be discussed. And here too my views will be based on material available for the application of the capitalization method of finding value. The terminal companies in the accounts of the user railways under the instructions of the Interstate Commerce Commission are treated as joint facilities and thus the payments made by the user railways are treated as expenditures reducing net railway operating income of the user companies. As a general thing the facilities of the terminal companies are paid for out of the proceeds of bonds issued by them. The payments made by the user railways are made to balance the expenditures of the terminal companies. In common parlance one hand washes the other. The payments of the user companies to meet the interest on the bonds of the terminal companies are net. There may be some net income from operation. By combining the contributions to pay interest and the net income from operation we have what corresponds to the net railway operating income of railways and thus we have the one thing needful for the application of the capitalization of the net income method to terminal companies.

The contractual payments of the user railways may be higher or lower than the present day contributions to earnings of the terminal companies justify. If too high the railway suffers and the terminal profits, and if too low the railway profits and the terminal suffers. But when the net income of both the railway and the terminal are considered the capitalization of net income methods allows no value to escape. As the terminals for the most part were brought into existence in the more prosperous era of railroading and as the payments to them by the railroads were fixed in the time of prosperity, the terminals are probably now being paid more than they are entitled to on the basis of their contribution to earnings. If a railroad has a beneficial interest in a terminal it appears in the net railway operating income of the railroad and swells the value shown for it by the capitalization of net income method of valuation. The user railways are billed for taxes by the terminal companies and I do not see how or why this arrangement should be changed.

We shall next consider "Use vs. Ownership as a Basis for Taxation" of cars owned by private car companies but used by railways. Under the prevailing practice the owners pay the taxes, and in the absence of a good reason for making a change this practice should be continued. The business relations of the car companies and the railways are adjusted to this practice. The railways are not in possession of information to enable them to argue the value or the average annual mileage of the cars with assessing officials and thus are not in a position to protect themselves. The property of the private car companies should be valued and assessed as units with allocation of this unit value to states. And finally, I think it goes without argument that long-established relations to which there is general adjustment and with which there is general satisfaction should not be radically changed because of a special and temporary situation.

And now we have come to the consideration of the taxation of what is known as foreign line cars. Should these cars be taxed where used or where owned? Under present practice they are assessed and taxed against the owning railway companies by the states in which the owning railway companies operate. Broadly speaking, the various railroads have equipment, apart from equipment furnished by the private car companies, sufficient to handle their traffic, and when the equipment of all the railways is assessed by the states in which the various companies operate each state gets substantially what is due. Assessment and taxation of railway-owned cars where use would require every railway to have a tax official in every one of our 48 states and the District of Columbia to protect their interests. In addition there would be more reports to be prepared and filed; and after all, the primary business of the railways is to transport passengers and freight. I look with disapproval upon requirements necessitating expansion of the clerical

force. We are getting to the point where, in the matter of reporting and keeping records, the force necessary has reached tremendous proportions, and it won't be long, if this thing continues, before the tail will be wagging the dog instead of the dog wagging the tail.

It was assumed earlier this afternoon, or stated rather, that twenty-five per cent of the equipment—rolling equipment—outside of that owned by private car companies, was not owned by the user. Now, I am wondering how that twenty-five per cent is made up—possibly by consideration of cars purchased by equipment trust certificates. The railroad with which I am associated has cars of that kind or equipment acquired in that manner. For taxation purposes we assume that that equipment is owned by the railway, and it is reported as a part of the railway equipment and so assessed. We also own a large amount of equipment, or hold a large amount of equipment, through a subsidiary company, but that subsidiary company is completely owned by the Santa Fe Railroad and is reported as a part of the equipment of the railway.

So far as fundamentals are concerned, I think that there hasn't been any difference, or isn't any real difference, between an earlier speaker of this afternoon and the views that I have specified, except in one respect. I think it is assumed, or was assumed by him, that there is a state of altruism existing on the part of states and corporations that doesn't really exist. States are reluctant to give any advantage in taxation matters that they have legally, and corporations are reluctant to give such advantages, and so far as these terminal companies are concerned, I don't very well see how an adjustment could be made. These terminal companies, on the basis of contracts between them and the railways, were financed by bond issues. These bonds run for many years. There are interest payments to be made. Now, I don't think the holders of the bonds of the terminal companies would forego any advantage that they have; they would say that when they entered into this arrangement, they took the possibility of the interest charge or interest rates going higher, and in view of the fact that they took this risk, they should have the advantage in the fact that the interest rates have gone higher. I don't look for any voluntary adjustment between a user railroad and an owner railroad; as long as the lessee is able to pay the amount called for in the contract, I think it is going to be called for, exacted. If he can't pay, there may be an adjustment. If, on the other hand, the other party to the contract finds it to his advantage that the contract be maintained, he will hold out, and go to court if necessary, to maintain that relationship. Now, if the desire exists to change from the ownership basis to the use basis, I don't think it would be very difficult to bring about arrangements, except for the parties concerned, who I think will be most decidedly stubborn and persistent in refusing to bring about or accept a readjustment. I thank you.

Presiding Officer: Well, after the dressing-down I just got for kind introduction, I don't know just how to introduce the next speaker. The only part which Mr. Tunell thoughtfully omitted to state was the fact that if I had learned much from him, he might have admitted—as he told me in the office the other day—that he didn't think I had learned much.

Now, I have some other old friends here in the audience and I don't know whether I had better say much about them or not. One man I have known a long while is Mr. G. E. Zubrod, the tax commissioner of the Louisville & Nashville Railroad. It is a pleasure to introduce him and to turn over to him the complete field, to ramble over or tread upon as he desires.

MINIMUM ASSESSMENTS FOR RAILROADS

G. E. ZUBROD

Real Estate Agent,
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I felt honored when invited to attend this conference and participate in the discussion. The president and I have been friends for a long time, dating back to his college days, when I was a poor, young railroad tax man. When Mr. Leland asked me to comment on the excellent paper we have just heard, by our good friend Wallace, I was glad to accept.

However, after considering his very able and enlightening discussion, I am wondering how he can arrive at the high value which he invariably places on my property.

Are commissions justified in adopting minimum values for operating railroads? As Mr. Wallace has just indicated, it would, of course, depend upon the laws of the respective states, but before attempting to answer the question, I must ask, "Would it be advisable?" I agree with Mr. Wallace in his conclusion that it would not.

I presume that some of my fellow tax agents may want to "skin me alive" for what I have to say.

No iron-clad rule can be formulated to assess all railroad property uniformly, but it would be easier to assess property of carriers which do interstate business if the same general method would be used to ascertain the assessments of all carriers. It appears quite difficult to value a railroad, in receivership, as its stock and bonds are practically worthless, and there are no earnings to capitalize, since the operators generally divert the surplus earnings, if any, to rehabilitate the property and to purchase much-needed new equipment. These railroads, if the usual methods of assessment were followed, would have no value whatever for taxation purposes, except such as is produced by the bare land and buildings.

It has been recognized that it is sometimes necessary to include in the formula an additional value or factor to prevent a very decided reduction in the railroad assessment in one year under another. Strangely, I do not recall the use of such value or factor to prevent an increase, when the railroads operated at a substantial profit, which, however, has not been the case for many years. It would appear that only recently one of the states, with large railroad holdings, used the I.C.C. valuation as one of the values to determine the assessment of the carriers. I am certain that the taxing authorities in that state will readily agree with the tax agents that the I.C.C. valuation should be used only as an allocation factor, and not in determining values, but it was used, I believe, in this instance to prevent a large reduction in the assessment of railroad property—one that would certainly disrupt many local budgets, with resulting deficits, default in payment of interest and other distressing conditions. Budgets are figured in advance of railroad assessments, and those who prepare budgets and tax levies have no guide other than the preceding assessments to use in their work; so it may readily be seen that sharp decline in railroad earnings, such as was experienced in the last quarter of 1937, would be disastrous to many local tax collecting agencies. If assessments followed earnings or lack of earnings too closely this situation would be without remedy.

Bonds are issued providing for payment of interest annually, and such commitments are based on known assessments. Therefore, after the bonds are issued, if assessments are sharply decreased, in counties depending on railroad taxes, default in payment of interest and sinking fund requirements might result. Likewise, railroads accrue, at the beginning of the tax year, amounts to cover the estimated taxes for that period, and should the reverse obtain and a large increase be given, it may prove embarrassing to some of the tax agents to explain to their superior why payments exceed accruals. Railroads, of course, desire reductions, but I believe the majority of tax agents desire, first, that their property be assessed fairly, and on the same basis as property generally in the respective states. If reductions are warranted, such as has been the case during the last ten years for many of us, I believe the proper procedure would be to grant them over a period of years, ultimately, of course, reaching the proper level for the property; therefore, I agree with Mr. Wallace that minimum values should not be given nor are they justified, in any one year.

For some time I have advocated, and no doubt others have also thought of the idea—if not actually proposing it—a plan, the merits of which, I believe, are slowly being recognized, whereby the railroads and taxing authorities would be in better position to anticipate the amounts to be paid out and received in taxes, regardless of a rapid and wholly unforeseen decrease or increase in railroad

revenues and in the market value of stocks and bonds. After arriving at the assessment for any one year, by employing the usual formula, the figure thus produced is added to the assessments for an agreed number of years, usually five, immediately preceding, and the result thus obtained divided by the number of assessments used, thereby determining an average assessment. Obviously, a rapid decline in any one year or portion thereof would be reflected but lightly in that year's assessment. Similarly, in a year of increased or above the average earnings, this increase would not be greatly reflected in that year but would serve to cushion a previous or later decline. I believe this plan, if fairly administered, and if both railroads and taxing authorities cease to take advantage of every rise and fall of business, would be a forward step to increase cooperation and understanding between the railroads, the tax-levying authorities, and the public generally. It would certainly obviate the necessity, in lean railroad years, for the formulation of a new plan of assessment in order to keep assessments near their former level, when figures ordinarily used do not justify it.

Therefore, I believe it is the common sense conclusion that neither *minimum* or *maximum* values should be used.

PRESIDING OFFICER: I don't know how many questions my good friend Mr. Worrall, tax agent of the Yorktown, Hooppole & Tampico—I mean, the Pennsylvania Railroad—can raise. I have saved his discussion until among the last and we will be glad to hear from Mr. Worrell at this time.

D. H. WORRALL: Dr. Leland very kindly gave me the opportunity of commenting on any of the papers which were presented.

I feel that Mr. Wallace very ably presented the opposite picture of the two papers addressed to subjects of "Alternative Use as a Valuation Factor" and "Are Commissions Justified in Adopting Minimum Values for Operating Railroads?"

Mr. McCrary demonstrated the dangers in competitive tax assessments.

My comments are limited, therefore, to Mr. Mitchell's paper, which I was very kindly allowed to review in advance of the meeting. There are many points in it which are commendable, but, in searching for a formula, it may be that adoption of indices of value as value itself has gone past the practical point.

In a property tax two problems are presented:

1st: To find value as defined under the statutes of each particular state; and

2nd: To treat that property, so valued, so that it bears its fair proportion of the ad valorem tax burden.

How far the unit method of valuation and later apportionment may accomplish this is difficult to state.

In the discussion of use vs. ownership as a basis for taxation there are many degrees—the principal items have been described by Mr. Mitchell. Under long-term leases and continuous exclusive use, use as a basis of developing the unit amounts in fact to pooled ownership. It is when short-term use, non-exclusive use and occasional use occur, that very careful analysis is required in order to avoid overlapping and duplication of values and creation of a unit out of things which in fact should never be included. There is no hard-and-fast rule which can be applied with any degree of accuracy.

At the opposite end of the picture would it not be advisable to consider enforcement of the tax burden? There is a point at which this may place a limit upon what may be properly determined as a unit. We are talking about property taxes. The property is primarily liable for the tax; after the property comes the responsibility of the owner. To attempt to shoulder this burden upon the user—without some clear contractural obligation—violates the fundamental principles of property taxation. Unless and until this concept of use is adopted by each state as the uniform basis for fixing tax incidence, its application to railroads seems but an additional burden which they may be called upon improperly to assume.

The topics have been interesting and were undoubtedly selected for a real need for clarification. They represent technical points in the problem of valuing railroad property. How far are they applicable or applied to other classes of ad valorem taxpayers? How far are the basic factors assumed in these discussions considered in valuing property of other ad valorem taxpayers. Frankly there seems no answer. Professor Daugherty has indicated a wide variation, both among authorities of different states and between authorities within states. Will better and more uniform bases for developing railroad value for ad valorem taxation cure the problem, and if cured are we then sure that the railroads have been properly rated in each state so that they are paying their fair share of the ad valorem taxes? The answer would seem to be a matter of equity which the modern technique discussed today fails to answer.

Presiding Officer: Mr. Martin, commissioner of revenue of Kentucky, is so well known he needs no introduction by me. We will next hear from Mr. Martin.

Mr. Martin: Fellow members of the conference: I was requested particularly by the president to discuss some of the issues of allocation or valuation—as you choose to look at it—which arise in connection with railroad properties composed entirely, so far as the situation within a given state is concerned, of valuable terminals and adjuncts to those terminals. The situation was one that I thought I would be able to deal with, with a good deal of vigor; but the more I studied it, the less I knew, so I invited the coopera-

tion of a number of eminent experts in the field of railroad taxation, and one of my friends gave such an apt answer to the problem that I want to pass it on to you. He said: " In your problem Number 2 [which was this one] you are tackling an impossible difficulty. The values must be assessed within the state but the values are not in the state."

I am inclined to agree with this expression by an eminent fellow member of the N. T. A., and it is in the light of that agreement that I have tackled the problem. I have attacked it because, despite its impossible character, it is one about which we have to do something, and the tax counsel of the railroads, as well as the tax commissions of the various states, are in the impossible situation of having to value this property despite the fact that there is no means by which it can be done. My paper, therefore, is designed to provide a partial provisional answer as I have guessed at it.

ASSESSMENT OF RAILWAY TERMINAL PROPERTIES

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The problem with which we are concerned involves the valuation, not of all railway terminal properties, but only of those situated in a state in which the owner or operator has little or no other property. A few illustrations will clarify the subject. A number of railway companies have no interest in Kentucky except in the city of Louisville. These include the Baltimore and Ohio, the New York Central, and the Pennsylvania. The Louisville and Nashville and Southern, which have terminal properties in Cincinnati, own little or no other properties in Ohio. The Louisville and Nashville, the Southern, the Illinois Central, and other railways have terminal properties in St. Louis but no extensive mileage elsewhere in the state. The various railways have terminal properties in the District of Columbia but have no extensive mileage other than urban line in that taxing jurisdiction; similarly in New York, in Omaha, and in numerous other cities. The present inquiry concerns the valuation of such terminals.

Commonly used, more or less complex allocation formulas, rest on a theory which is inconsistent when applied to this particular type of property. For example, gross receipts allocated to a terminal according to the usual formula will understate the actual terminal gross receipts and will bear no reasonable relation to them. In such instances a measuring-stick different from that used for railroads having substantial property both within and outside the assessing state is required. Similarly, traffic units and track mileage, as well as car and locomotive mileage, will give a distinctly

skewed picture, so that as a practical matter these measures are of relatively little importance in allocating railroad properties under such circumstances. Moreover, the difficulties inherent in the situation are oftentimes greatly enhanced by the railroad's provision of expensive incidental facilities additional to the normal terminal properties themselves. This would not blur the picture but for the fact that such facilities are ordinarily completely out of line with the normal value of properties used by railway companies. Thus, in the instance of the Louisville, Cincinnati, Washington, New York, and Omaha terminal facilities already referred to, many of the railways own expensive bridges or tunnels over or under large streams; and some allocation on account of these properties, completely out of keeping with the normal value per mile of track, will have to be made to conform with constitutional requirements in the terminal taxing jurisdictions.

The problem is confused further by the fact that operating plans in one case differ from those in other cases. For example, in one instance a railway system may directly own and operate the terminal facilities; in another it will maintain a subsidiary corporation, sometimes jointly owned by other railway systems, for the purpose of owning and operating the bridge and terminal properties. Again, the properties may be leased either from a belt line company or from another railway system. The most difficult arrangement of all, however, occurs when the terminal facilities are operated over trackage rights, as in the case of the Baltimore and Ohio in Louisville or the Chesapeake and Ohio in Chicago.

From the point of view of assessment theory, two fundamental classes of issues are raised. Each involves intricate problems of engineering, legal, and economic theory. If one approaches the assessment of such properties from the viewpoint of the unit method of assessment, with an allocation to the taxing state, the assessment difficulties will have to be attacked on the basis of a different set of theoretical assumptions than will characterize an approach based on a direct appraisal of the local properties without reference to the prosperity of the system. The issues arising in connection with the independent appraisal attack on the valuation problem should be considered separately, although there may be some justification for using both.

In connection with unit assessments of railroads, there is approximate agreement that substantially equal weight should be given to property factors and to operating factors, and that each should be measured by at least two criteria.[1] Thus, in Kentucky we employ

[1] National Tax Association, *Proceedings*, 1923, pp. 403 ff.; Illinois Tax Commission, Fifteenth *Report*, 1933, pp. 194-6; R. G. Blakey and others, *Taxation in Minnesota*, chap. 11. See to the contrary, W. T. Faricy, National Tax Association, *Proceedings*, 1937, pp. 251 ff. — a view which is somewhat modified in a letter from Mr. Faricy dated September 9, 1938.

two property factors, namely, all-track mileage and reproduction cost new plus net additions at cost, and two operating factors, namely, allocated gross receipts and traffic units. (Traffic units in some states are computed on a weighted basis, giving two- or three-fold emphasis to passenger mileage; but in Kentucky we simply add passenger mileage and ton mileage of freight to secure our traffic unit fraction.)

The general theory underlying the use of the property criteria is that the physical property situated in a state gives rise to necessary governmental expenses for protection and that, therefore, the proportion of the property actually located in the state is one of the measures that should be employed in making an assignment of values between the taxing state and all other states. Property is also a proper criterion for income allocation.[2]

With respect to traffic units and allocated gross receipts, the underlying justification rests on a different set of assumptions. The property of any taxpayer is valuable, so the theory runs, if it contributes to the earning of income; it is without value if it fails to do so. Thus, any part of the property of a railroad system has value depending on whether or not the particular property contributes to the earnings of the system as a whole, and the value of the properties may be regarded as proportional to their contribution to the railway system's prosperity. It will be accepted in the light of state and federal income tax theory and practice that property criteria have some validity in this same connection, but it would doubtless be contended that operating factors are more significant than are physical property factors as such.[3]

For the purpose of dealing with the assessment of terminal properties of railroads, it is essential that the application of these principles to terminal properties in states where the railroad system has no other property be understood. If traffic units as ordinarily measured or gross receipts allocated on a line-haul basis are applied to terminal switching, it is apparent that no fair index of the contribution of the terminal to the value of the system is reached. Moreover, adding complicating factors will not in such an event eliminate the error introduced by these improper measuring-sticks.

Because the trackage in and near large cities is likely to be very much more valuable or very much less valuable than that of the road as a whole, allocation on the basis of trackage will inevitably involve considerable error; though perhaps all-track mileage is a less objectionable factor than traffic units or gross receipts.

[2] For a more adequate discussion of the theoretical framework, see J. P. Jensen, *Property Taxation in the United States*, chap. 3.

[3] See Mr. Faricy's discussion above cited. Note also R. S. Ford, *Allocation of Corporate Income for Purposes of State Taxation.*

The theory of separate appraisal without regard to the value of the railroad system as a whole is based on an engineering approach to assessment, which under many circumstances may be unconstitutional and which under certain other circumstances, though not perhaps completely arbitrary, would result in gross over- or undervaluation of the properties. The reason for this conclusion is that it is not to be expected that the value of a railroad, either in whole or in part, is the same as the cost of reproducing that property, even though appropriate allowances for depreciation are made. One modification of a direct engineering appraisal on a reproduction-cost-less-depreciation basis is such an appraisal adjusted to reflect the normal changes in value of railroad properties from the depreciated reproduction cost. This adjustment unquestionably results in a closer approximation of a fair appraisal than do unadjusted reproduction cost figures.

Moreover, it is probable that any appraisal method of dealing with this problem will result in a less than adequate allocation to the terminal in the event the operating railroad utilizes only trackage rights in the terminal state. However, for those cases in which the railroad system operates into and in the terminal over owned, leased, or controlled mileage, the appraisal method cannot be discarded as entirely arbitrary. Possibly the best method of adjustment when the appraisal method is used is that which will reflect the average decline in railroad valuation in the entire section from depreciated reproduction cost. (The converse of this situation would, of course, exist if at sometime in the future railroad properties on the whole should be worth more than reproduction cost less depreciation.)

Probably a more accurate method of appraisal is exemplified in unit value of the system allocated on the basis of reproduction cost new plus net additions at cost. This is the only allocation factor which really makes sense when applied to conditions such as those under consideration. It is probably the allocation factor which, standing alone, is least unsatisfactory for general purposes.[4] It is subject to the objection that, if standard allocation formulas are employed for the bulk of a railroad's mileage and if reproduction-cost data alone are employed in the case of large terminal properties, the total value assessed against a railroad will be sometimes more, sometimes less, than the actual 100 per cent. As has so frequently been said, although this is a theoretical objection, it is impossible on an arbitrary or any other basis to arrive at an assessment of a large, far-flung property situated in many taxing districts which will exactly add up to 100 per cent. A method of valuation and of allocation in such a case should seek rather to reach as close approximation of this happy result as is possible without arbitrary

[4] See National Tax Association, *Proceedings*, 1937, pp. 286-87.

discrimination against any of the taxpayers, on the one hand, or any of the taxing districts, on the other. The method of approach outlined seems to reach that result.[5]

It may be suggested that in combination the independent appraisal method and the unit assessment allocated on the basis of reproduction cost new plus net additions at cost will reach a result more defensible than the result attained by an allocation method such as has been described used alone. On the basis of analysis thus far available, I think this is error, though I am quite ready to admit that further study might justify a different conclusion. This is one of the difficulties to which I have as yet found no answer that is really satisfactory. Another of the same class, it may be said parenthetically, may be found in the instance of a carrier operating in the terminal state over trackage rights.

One final observation is essential in order to complete the summary picture. Under the conditions confronted by railroads at the present time, it is possible that system values in some instances arrived at by either of the methods developed above would assign to a terminal state aggregate value less than the alternative values of the land plus the market value of the railroad terminal property and rolling stock at second-hand. For instance, the southwestern carriers having terminals in Memphis have reached such a low state of prosperity that a fair allocation of the system value to Tennessee might be less than the value of the land alone for industrial purposes plus the second-hand value of improvements and the market value of the rolling stock. If this is the case, then the local land value plus the second-hand value of other property would constitute a level below which the terminal property values could not go. This reservation seems to me necessary if properties of other types are to be protected against discrimination in favor of insolvent railroads. It goes without saying that no matter how railroad property values are arrived at, they should be subject to equalization to conform with the average over- or undervaluations of other properties in the state.

In respect to the last reservation, I may say that I have some misgivings, particularly in the light of some of the facts developed by Mr. Wallace, which go farther than I had thought at the time I wrote this paper. I am disposed to think, however, that the reservation is a proper one, provided the expense necessary to adapt the land be given a proper weight, and that, it seems to me, is not an impossible chore.

[5] These authorities agree in substance: James C. Bonbright (letter of September 19, 1938); J. S. Lillie (letter of September 18, 1938); C. C. Chapman (letter of September 10, 1938); W. T. Faricy (letter of September 9, 1938).

PRESIDING OFFICER: The meeting is now open to general discussion from the floor as the spirit moves you, and we will proceed under the seven-minute rule as long as we can.

MR. BECKETT: Mr. Chairman, with reference to the state of New Jersey, I want to undertake to make a remark about it for two reasons. I spent several months last year making something of a study of that tax situation; the second reason being that one of the chief railroad tax burdens in the country is in New Jersey. New Jersey railroad taxes are not merely out of line on a mileage basis with the balance of the country, but they are ten times as great per mile as in the average of the other states. Out of a total railroad tax bill of $220,000,000, $20,000,000 is paid in New Jersey. This situation is supposed to be justified by the great value of the railroad lines in Hudson County. When I discussed the matter with the local people, I got the impression that the commerce of the country would stop if Hudson County were bottled up. The valuation of lands in this county is far in excess of their cost, far in excess of their I.C.C. valuation. The state law provides railroads can't sell lands without the consent of the public authorities, and those railroads that have tried to dispose of portions of their property have had petitions denied. They have now succeeded in getting rid of some parcels by taking them out of use and letting them be sold for taxes.

MR. JAMES (The C. R. R. Co. of New Jersey): I would like to ask Commissioner Martin of New Jersey a question or two. He made the statement that the terminal properties on the Hudson County waterfront were valued on the basis of what the property would bring on the open market. Would he say the law of supply and demand reflects the value of that property? There are literally hundreds of miles of unused vacant riverfront property immediately adjoining, and some of it in Hudson County. He indicated that all that land available for use or sale has a value. We have a parcel of forty acres known as the "King property" that we will be glad to sell at anywhere near its assessed valuation, and if he will give us an offer twenty-five per cent below the assessed valuation, we will be glad to entertain it and present it to the president of our company within twenty-four hours.

COMMISSIONER MARTIN: I understood Mr. James to say he wanted to ask a question but I did't quite get what that question was. I would like to ask him, before I attempt to make an answer, in what municipality the property he mentions is located, because there is a vast difference between values in different sections of the Hudson River waterfront.

MR. JAMES: The property in question is just to the south of Weehawken Ferry. I haven't been in Jersey now for over ten years and I have forgotten what municipality it is.

Commissioner Martin: In answer to the implied question, this property is on the northern edge of a valuable section. The Weehawken docks comprise the northern limit of what we consider very valuable waterfront. Two weeks ago, on the occasion of an inspection trip that was made by a party including the railroad counsel for the state and the state board of tax appeals, I was told that a piece of property lying just south of this point was being purposely held off the market by the owner, that it was not owned by a railroad but was being purposely held off the market by the owner because of its connection with railroad property. If, in fact, there is a piece of property along the stretch from Weehawken down to Hoboken that is for sale at any appreciable figure below the railroad assessment of the nearest piece of railroad property, I am quite satisfied from my knowledge of what is going on there that if the gentleman will write me a letter I will find a broker who will take the property off his hands.

Having been called upon to occupy the floor for a minute, while I am up here, I would like to say that Commissioner Martin of Kentucky stated, near the very end of his paper, the thesis of our Jersey theory of taxation—that is, the value at which bare land would be bought by somebody else, if it were offered for sale, is certainly a minimum for its taxable value. Now, if anybody wants to appeal from our determination of what that salable value is, they may do so. The railroads in New Jersey have a right to appeal on that specific question and they litigate it every year. The railroads put in their evidence of what sales there have been, the state puts in evidence of what sales there have been in that particular section. The board of tax appeals has frequently raised the valuation in the light of evidence presented at these hearings—that is, has raised the valuation above the assessment fixed by the tax department, based on actual sales of property in the vicinity.

Another of the speakers, Mr. Zubrod, stated our position in a nutshell. He considered the problem of finding the value of a railroad which is in receivership and he suggested, as I understood his language, that if the railroad wasn't earning any net income, there wouldn't be any taxable value except for the bare land and buildings. Well, that is all we tax in Jersey today. When railroads are prosperous, we do put a value on the franchise and that represents a value about which there might be a difference of opinion between terminal states and bridge states; but it is our belief in Jersey that when the franchise is of no value—that is, in days like these—the taxable value of property is certainly no less than what somebody is willing to buy that property for. The first gentleman that spoke from the floor said that Jersey railroad taxes were out of line with railroad taxes generally. As I said in my formal paper, all taxes in Jersey on real property are out of line with what they are in any other state. We have an average tax rate in the state of $4.50

a hundred on the assessed valuation on real property. We have some municipalities where the tax rate is $10.00 a hundred.

QUESTION: Why is that?

COMMISSIONER MARTIN: As I said in my paper, because we don't have any tax in Jersey — any substantial tax — on business. The entire revenue of the municipalities is derived from a tax on property and the local assessors hardly ever assess intangible property and never assess personalty for anywhere near what it is worth. The tax revision commission in Jersey is endeavoring to discover means by which the burden on real estate can be relieved. I could point to block upon block of city office buildings in Newark that are not today earning their operating expenses. They nevertheless have to pay a tax in the city of Newark of over $5.00 a hundred on the assessed value of those buildings. That is a serious situation and the state is endeavoring to correct it. When it is corrected the railroads will be relieved in the same proportion as all other real estate and business or wealth will pay a little more of the tax burden than it is now paying.

PRESIDING OFFICER: Are there any other questions?

COMMISSIONER MARTIN (Kentucky): Mr. Chairman, if I may be pardoned, I should like to disclaim responsibility for passing any opinion on the New Jersey method of attack on our problem here. It seems to me that New Jersey, at least as respects most of the railroads involved, does not qualify under the terms of what I designated as my "defeatist" attack on the problem of assessing terminal properties when the carrier has no other property of any substantial moment in the state. At least most of the carriers in New Jersey have a good deal of other property and therefore do not come within the purview of my remarks in that connection.

Perhaps I may be able to assist in one other respect in regard to the New Jersey situation. It was my privilege to make a study a year or two ago of the financial problems of the District of Columbia in a report which I believe is entitled "The Fiscal Relationships Between the Federal Government and the District of Columbia." We made a very careful check on the actual tax rates as distinguished from the nominal tax rates in other cities comparable to Washington, D. C. and found that the larger cities of New Jersey did, as a matter of fact, have effective tax rates completely out of line with the average city of the same general size in other sections of the United States.

MR. TUNELL: Mr. Chairman, I wish to arise to a matter of personal privilege—the question of the competence of the tax commissioners of the railroads was raised a few minutes ago and that table was called into use. It was declared that when the matter was put to them in the form of a question, the railroad men did

not state with accuracy the value of their properties. I think the professors of logic contend that if reasoning by analogy is adopted, analogy must run on all fours. Now, if the question had been asked about the length of our railroad or the weight of its rails or anything of that nature, definite answers could have been given. If, on the other hand, the question had been asked the members who are here the value of that table, then the analogy would have run on all fours, and I dare say that a variety of answers would have been received as to the value of that table.

Mr. Daugherty: My statement was that I asked the railroads' tax commissioners to tell me the assessed value of their system as it was assessed by the state tax commissioners. Mr. Chairman and Mr. Martin are both looking at the same railroad and valuing it. They have the same criterion of value, its commercial value—what a willing buyer would buy it for and what a willing seller would sell it for. One of them takes it to be $100,000,000; the other, $200,000,000. I admit if you would call in a half a dozen second-hand dealers and ask them to value that table, there would be a variation of possibly twenty-five per cent, but there wouldn't be a variation of one hundred per cent. Now, it seems to me that when both of you are undertaking to value the same thing and using the same criteria of value and arrive at markedly different results, somebody is wrong. I don't see any way you can get out of it. I admit there are differences of opinion but when you get a difference of one hundred per cent, it seems to me that somebody must be guessing.

Presiding Officer: Now is there anybody who hasn't spoken that would like to say something?

Mr. Chapman (Wisconsin): I would like to ask a question of Mr. Daugherty. Did those people use the same stock and bond values and the same capitalized income?

Mr. Daugherty: Yes.

Mr. Chapman: They must have been using something else with it.

Mr. Daugherty: They did; some of them used stock and bond value, some used reproduction cost, and some of them used judgment, but the difference was one hundred per cent.

Mr. Thompson (The C. R. R. of New Jersey): I would like to express a little difference of opinion with Mr. Martin on the question of alternative use. We believe there is a legal objection to using alternative use, but in addition to the legal objection we believe that the determination of the value by considering alternative use is extremely speculative. For instance, Mr. Martin spoke of the

ease with which this waterfront terminal property could be sold. Three months ago, one of the railroads sold a parcel of this property for $285,000 which was assessed for $1,176,000. Three weeks ago a piece assessed for $240,000 was sold for $140,000. As to abandoned lines—we abandoned a line assessed at $35,000 and after the tracks had been pulled up but with the grading still there we can hardly give the land away. It is for these reasons that I believe that in addition to the legal objections to alternative use there is the objection that the actual sale price in alternative use is highly speculative.

COMMISSIONER MARTIN (New Jersey): In response to the speaker from Jersey City, Mr. Thompson, and in regard to his comparison of sale and assessed values of two parcels of railroad property: inasmuch as his railroad is engaged in litigation, it naturally might be considered free to endeavor to do something to affect the course of that litigation. He neglected to tell you that when they sold that piece of railroad property for the price that he mentioned, they got in addition to the cash consideration an agreement for exclusive traffic rights and freight privileges for that property for a considerable period of years. This right has a monetary value. I wouldn't attempt to say how much of the difference between his selling price and the price he says I placed on it is represented by those traffic rights. I am speaking now with only a slight knowledge of the details of the contract, but there is a whole lot more consideration involved in that sale than the cash changing hands.

PRESIDING OFFICER: It has occurred to me, as I have listened to the discussion here today, that among the unsettled problems which seem to be of interest are the taxation of joint facilities; the apportionment of system unit values to single factors making up the unit, particularly to rolling stock, and rights connected therewith; the adjustment of valuation indices to take account of inadequate or excessive maintenance, depreciation or obsolescence; the adjustment of the I.C.C. values so that they more nearly reflect market conditions; and, finally, the possibility that we might postulate for both the state tax commissioners and the railroad tax attorneys a problem, in which all the facts were stated, and the methods and procedures for handling these facts were on the table. It might be profitable for you to consider these and related problems and if you want to discuss railroad taxation in the future, let the program committee know about it. I am sure that, by the way you have patiently sat here this afternoon, you are gluttons for punishment; I shall therefore adjourn the meeting.

ROUND TABLE V

Grants-in-Aid and Sharing of State-Administered Taxes: What to Share, How to Share, and How Much

Presiding Officer

Harold D. Smith, Budget Director, State of Michigan.

Recording Secretary

Albert Lepawsky, Executive Director, Federation of Tax Administrators.

Opening remarks and basis for discussion by Harold Smith.

Participants:

Mabel Newcomer, Professor of Economics, Vassar College.

Professor Fritz Karl Mann, American University.

Henry J. Bittermann, Associate Professor of Economics, Ohio State University.

Robert S. Ford, Director, Bureau of Government, University of Michigan.

William Campbell, Michigan.

Frank J. Murray

M. H. Hunter, Professor of Economics, Univ. of Illinois.

Roy G. Blakey, Professor of Economics, Univ. of Minnesota.

Chairman Smith presented Carl Shoup's paper.

Harold M. Groves, Associate Professor of Economics, University of Wisconsin.

Henry F. Long, Commissioner of Corporations and Taxation, Massachusetts.

Recording Secretary, Harold Smith, the presiding officer, introduced the subject by stating that grants-in-aid and shared revenues are merely a fiscal reflection of the increasing interdependence between localities and sections of the country. This interdependence has resulted in the necessity of interlacing governments on the fiscal as well as the political and administrative levels. The degree of interlacing varies with current developments and theories of government, but the form will always tend to include some such devices as grants-in-aid and shared revenues.

Mabel Newcomer, professor of economics, Vassar College, started the discussion with the following paper:

PROPOSED CLASSIFICATION FOR CENTRAL GOVERNMENT AID TO LOCAL GOVERNMENTS

I. Suggested Classification for Central Government Aid to Local Government

Central government aid to local governments may be classified (1) according to the source of the revenue, as aid from general revenues or specific taxes; (2) according to the use to which it is to be put, as aid for general purposes or specific purposes; (3) according to the factors determining the amount of aid; or, (4) according to the decree of control exercised by the authority providing the aid. The classification that I am suggesting for consideration is based on a combination of the second, third, and fourth factors. Sources are ignored except when the source determines the amount of aid.

I. *Shared tax:* amount determined by the yield of a specific tax
   - A. *Earmarked tax:* purpose for which money is to be spent is specified. May be distributed on equalization base, and may be conditioned on specified standards of local administration
   - B. *Free revenue:* no restriction on expenditure. Usually returned where collected

II. *Grant-in-aid:* amount determined independently of the yield of a specific tax
   - A. *Fixed grant:* no change in amount from year to year
     - 1. *Block grant:* no restriction on use
       - a. *Conditional grant:* all or part may be withheld if local authorities fail to perform specified tasks according to specified standards
       - b. *Unconditional grant:* no administrative discretion
     - 2. *Allocated grant:* purpose for which money is to be spent is specified
       - a. *Conditional grant*
       - b. *Unconditional grant*
   - B. *Variable grant:* amount varies with expenditure or need
     - 1. *Block grant*
       - a. *Conditional grant*
       - b. *Unconditional grant*
     - 2. *Allocated grant*

a. *Percentage grant:* amount varies with expenditure
   (1) *Conditional grant*
   (2) *Unconditional grant*

b. *Equalization grant:* amount varies with need
   (1) *Unit grant:* amount varies with need as measured by school children, miles of highway, and other objective measures
      (a) *Conditional grant*
      (b) *Unconditional grant*
   (2) *Formula grant:* combination of several units, or units and percentage of expenditures
      (a) *Conditional grant*
      (b) *Unconditional grant*
   (3) *Discretionary grant:* distribution left entirely to administrative decision
      (a) *Conditional grant*
      (b) *Unconditional grant*

Two considerations have guided the suggested classification: accepted usage and distinctions useful to the theory of state aid. It is not always clear, however, that there is any widely accepted usage.

Central government aid is first divided into grants-in-aid and shared taxes. This distinction is commonly made in this country, but obviously there is no clear dividing line between the two. "Shared tax" has been defined to apply to aid the amount of which fluctuates with the yield of a specific tax, and "grant-in-aid" has been defined to apply to aid the amount of which is determined independently of the yield of a specific tax. It is important to distinguish between aid that has been determined, at least in the beginning, by some measure of local need, and aid the amount of which is independent of need and that, in practice, tends to vary inversely with need. Also, this distinction is widely used. The census publications *Financial Statistics of Cities* and *Financial Statistics of States* make this distinction, including grants-in-aid (as subventions) in state revenues, and including shared taxes with local tax revenues. Dr. Bittermann, however, limits shared taxes to those distributions of specific taxes for which there is no specified object of expenditure, including the remainder with grants-in-aid (H. J. Bittermann, *State and Federal Grants-in-Aid*, 1938). This definition of shared taxes is synonymous with what I term "free

revenue." Sidney Webb's definition of a grant-in-aid is broad enough to include all shared taxes (S. Webb, *Grants in Aid*, 1920). There is nothing comparable to our shared tax in the English system that he is discussing, however. Even the former "assigned revenues," which were essentially shared taxes as distributed to the counties, were converted into grants-in-aid, as I have defined the term, when redistributed to the local subdivisions of the county.

The sub-classification of grants-in-aid follows Finer's classification fairly closely (H. Finer, *English Local Government*, 1933). The distinction between fixed and variable grants serves to distinguish further the degree to which aid is adapted to local needs. The subdivision of fixed and variable grants into block and allocated grants, as well as the subdivision of shared taxes into earmarked taxes and free revenue, is useful in indicating the degree of local freedom in allocating the aid received.

The division of allocated grants into percentage and equalization grants indicates the primary purpose of the grant. The first is ordinarily to stimulate the local government to increase expenditures for specific functions. The second is to aid the poorer districts so that they can provide a reasonable minimum of services. The differentiation of equalization grants into unit, formula, and discretionary grants is of lesser importance, indicating merely the method of equalization.

The distinction between conditional and unconditional grants is of major importance. This classification cuts across all the preceding ones. All grants and all shared taxes are conditional or unconditional. The conditional grant gives the central authority administrative discretion to withhold all or a part of the grant if local governments fail to meet central government standards for the performance of functions for which the aid is designed. In making this distinction between conditional and unconditional grants I have deviated from common usage. A conditional grant more commonly is defined as synonymous with what I have called "allocated grants" (see, e.g., J. A. Maxwell, *Federal Subsidies to the Provincial Governments in Canada*, 1937). As far as I can ascertain, however, those using the terms in this way have not attempted to present a comprehensive classification, but have been dealing with a grant system in which only allocated grants had any conditions attached.

No particular brief is held for the exact terminology used, nor for the relative importance of the distinctions made. It is believed, however, that general agreement both as to classification and definition of terms will contribute much to the clarity of our thinking in this field.

II. Types of Taxes that are Suitable for Sharing with Subordinate Governments

The fundamental reason for federal or state sharing of taxes with subordinate governments is that the wider jurisdiction makes possible more effective administration. The occasion for sharing may be compensation for the loss of tax revenues when the central government takes over a former local tax or cuts into the base of a local tax. Or, the occasion for sharing may be to meet local need for new revenue, either for a specific purpose or for general use.

Considering the problem from the angle of efficient administration, there is probably no tax that cannot be administered more effectively by a wider jurisdiction than by a narrower one. As long as some degree of local independence is tolerated, however, some degree of efficiency must be sacrificed. The problem as between state and local governments is not the selection of those taxes that can be most effectively administered by the state, since all the important taxes other than the property taxes are administered by the state. The problem is to select those state-administered taxes that may be shared with local governments with the greatest benefit to local governments and the least risk of irresponsible expenditure.

This, in my judgment, requires, first, selection of those taxes with relatively stable yields, — that is, sales, liquor, and motor vehicle taxes rather than taxes on net income. The state is so much better able than the local governments to adjust its finances to prosperity and depression that the brunt of the burden should fall on it. In the second place, distribution of the tax should not be erratic, giving small jurisdictions astonishingly large returns, and larger and poorer areas little or nothing. If tax revenues are to be returned where collected this means selecting for distribution taxes with a wide base, the yield of which tends to vary directly with population, and avoiding special business taxes, such as corporation income taxes. There is, however, no necessity for returning a shared tax where it is collected; and if another standard of distribution is to be selected, the problem becomes one of finding an equitable measure of need and not one of selecting the tax to be distributed. Finally, there is probably some advantage in tying the source of revenue to the purpose of expenditure. The motor fuel tax, on this criterion, is probably the most satisfactory tax for state and local sharing. Certainly it is the one most generally used.

Turning to the federal-state problem, unless we are to abandon the federal form of government the states must have a wide range of independent revenue sources. The choice of taxes that the federal government might share with the states should rest, in my opinion, largely—if not entirely—with the relative effectiveness of federal and state administration. As in the case of state and local administration, it seems probable that the larger jurisdiction can administer any tax more effectively than the smaller jurisdiction, but the differential will be far greater for some taxes than for others.

If the federal government were to adopt a program of sharing, I should favor sharing of the personal income tax, the estate tax, and the liquor tax. These are taxes for which the federal and state governments are now in active competition, and uniformity is therefore, important. Whether uniformity should be achieved by a single, federal administration, or through the crediting device, rests with the relative economy of the former as compared with the greater state freedom and responsibility obtained by the latter. Unless and until the federal government decreases the amount of the exemptions from these taxes, the crediting device is preferable since it is important for the states to be able to reach the smaller incomes and estates. For the liquor tax, single administration and uniformity would greatly increase the effectiveness of administration; and a simple per-capita distribution would probably be acceptable. The same general reasoning applies to gasoline, tobacco, and general retail sales taxes. However, separation of source seems to me to be preferable for the gasoline and tobacco taxes, since the states, in practice, have established a prior claim to gasoline taxes and the federal government to tobacco taxes. And I should regret any step that led to increased retail sales taxation. At the bottom of the list of taxes to be shared by the federal government with the states, I should place customs duties—for obvious reasons—and corporation income taxes. The interstate character of much of the corporation activities makes it difficult to allocate the proceeds fairly to any specific jurisdiction. However, if there is to be no attempt to return the proceeds where collected, much the same argument for sharing applies to this tax as to the personal income tax.

Viewing the matter as a whole, I believe a moderate use of shared taxes is a relatively harmless device, but I have a strong preference for grants-in-aid.

Professor Fritz Karl Mann, of American University, at the conclusion of Miss Newcomer's paper, inquired about the levy of local taxes in addition to existing state levies, which, although not mentioned in Miss Newcomer's table, are used in certain European countries as equalizing taxes permitting certain local communities to increase their tax revenues if they so desire. Professor Mann stated that there was a relationship between the loss of local autonomy and democratic control in European countries and the extensive development of the grant-in-aid system there. Miss Newcomer explained that intermediate taxes should be classified as intermediate not between shared revenues and grants-in-aid but rather between direct local taxes and shared revenues, and are therefore left out of the discussion.

Henry J. Bittermann, associate professor of economics, Ohio State University, then presented the following paper:

GRANTS-IN-AID, TAX SHARING AND THE TRANSFER OF FUNCTIONS

The fairly general collapse of the general property tax in the depression period and the necessity for relief and works expenditures on an unprecedented scale resulted in drastic financial and administrative changes. The devices used for readjustment, however, were not new, for grants-in-aid have been in use for over a century and shared taxes have been part of the financial systems of some states for decades.

It will generally be conceded, it seems, that larger units of government can administer some taxes, as corporation income, inheritance, gasoline, and motor vehicle taxes, more efficiently than smaller units. Larger governmental units can decrease evasion and avoidance; they can levy progressive rates with less fear of migration of persons or industries; they can more easily avoid multiple taxation of the same property or income. While there are non-fiscal arguments for grants-in-aid, the evidence indicates that the problem of grants-in-aid and shared taxes is not relevant in the absence of greater productivity of central (as compared to local) taxes or borrowing capacity. Traditionally there has been a fairly complete separation between the taxing and spending functions of the federal and state governments. On the other hand, state and local activities have been closely related. Assuming, then, that central taxes will increase in proportion to the total, the problem of adjustment arises.

There are three alternatives though not mutually exclusive devices for dealing with the situation: (1) the distribution of part of the central taxes among local authorities, without specifying the use to be made of the shares; (2) periodic grants-in-aid from the central to the local government, for specified purposes or functions; and (3) a transfer of some functions from smaller units to larger units having greater taxable resources. There is a fourth alternative in use in Europe, local additions to centrally collected taxes, but this device has not often been tried in this country. Each of these devices has certain advantages and disadvantages, which, presumably, will be brought out at this meeting.

Only a very brief and inadequate summary of the history of this question can be attempted here. State grants-in-aid for schools started in New York in 1795, and in other states in the early years of the last century. Almost all of these school subventions originated in the distribution of income from investment funds, though in time other windfall revenues were added, and subsequently some taxes were levied by the states for the specific purpose of aiding local schools. As long as the states depended on property taxation the grants were rather small, and in large part returned the funds to the areas where collected. With increased revenues from corporation,

income, and other taxes in the last twenty years, the amount of the school grants increased rapidly and redistribution became an avowed objective. In 1890 school subventions amounted to about $34,000,000, in 1920 to $160,000,000, and in 1934 to $423,000,000. They were largest where the state taxes were independent of local sources or where special revenues were earmarked.

After a few experiments in the pre-railroad age, highway grants-in-aid revived in the eastern states in the nineties and spread rapidly elsewhere before the war. In 1904 they were less than $1,000,000; in 1915, $17,000,000; in 1936, $386,000,000; and in 1937 about $408,000,000. At present almost two-thirds of the highway grants-in-aid consists of shares of gasoline and registration taxes, while the balance is largely derived from these taxes indirectly through the highway department budgets.

Federal grants-in-aid originated in the surplus revenues of the latter part of the last century, and many of the proposals for highway aid in the early days may best be described as attempted distribution of "pork" by formula. Unlike state subventions, which are predominantly aid toward the general cost of fairly well established services, federal grants have been mainly for new lines of work, such as agricultural research, extension work, vocational education, and forest fire prevention. Total federal grants rose from $2,703,000 in 1902 to $238,068,000 in 1932, and in the latter year formed almost 11% of state revenue. The depression caused drastic changes. Relief passed rapidly from county to state administration and federal funds paid most of the bill. In 1934 total federal grants-in-aid amounted to $971,000,000, in 1935 to $2,160,000,000, and in 1936 the total dropped to $1,004,000,000, and in 1937 to about $800,000,000. These decreases were due not to lower relief costs but to the fact that W.P.A. spends federal money directly without passing it through the state treasuries. P.W.A. still grants funds to both state and local authorities. At present the largest grants are for highway work, works construction, and social security. At the 1935 peak, federal funds provided almost 30% of the state revenues.

As early as 1865 Massachusetts began the practice of sharing corporation taxes with the towns in proportion to the local ownership of stock, a practice that was soon adopted elsewhere in New England. Obviously this was in place of local taxes on the stock. Many other states have since adopted some form of sharing special corporation tax revenues, and also income, inheritance, sales and excise tax revenues. If motor tax distributions are excluded from the category of shared taxes, since they are almost invariably earmarked for highway work, tax-sharing, at least before the depression, appears mainly in New York, Massachusetts, and Wisconsin, with very small amounts shared in other states. With the depression more taxes have been shared, but in the absence of satisfactory

compilations it is difficult to state what their amount and importance may be.

No state, as far as is known, has completely transferred schools to state administration, although North Carolina and Delaware practically support the entire educational program from state funds. Several states, North Carolina, Delaware, Virginia, and West Virginia, have in depression years assumed complete responsibility for rural roads, and Pennsylvania and Louisiana have taken over very large parts of the local work.

A conclusion about desirable public policy necessarily involves two elements, inferences about the operation of various governmental devices, and preferences in matters of political theory. This applies to our present problem as well as others. For convenience the federal problem may be dealt with separately. Federal tax sharing is doubtful constitutionally, especially in view of the supreme court opinion in the processing tax cases. Relief has been largely transferred, although that may be a temporary situation, while the permanent problem is left to the social security act grants-in-aid. Obviously there are not many state and local functions that could be given the federal government, even if it had a surplus of revenue, while still preserving the main features of our political system. In practice then, if the federal tax system is to be used for state revenue, it will necessarily be in the form of grants-in-aid, or possibly state additions to federal income tax.

For state and local relations, however, there is a real choice between grants-in-aid and tax sharing or transfer of spending functions. Tax sharing permits the greatest local autonomy. While the revenue comes from state taxes the locality may spend it as it prefers, and the local bodies may have a better understanding of their needs than a state legislature, especially where rural and urban interest conflict. The tax-sharing policy coincides most closely with the American tradition of amateur localism, and also with the view of Anglo-American finance theory, which deprecates the use of taxation for non-fiscal ends. On the other side, there may be a temptation to waste money not coming directly from local taxpayers. Furthermore, the complexity of local government would result in practice in different burdens in various areas if taxes are shared solely with one type of authority, e.g., the counties, and, if the tax share is given to all units, each will receive too small a share. Since the amount of taxes shared fluctuates violently with the economic cycle, sharing may encourage waste in prosperity and compel resort to heavy property taxation in depression. Finally, it seems difficult to find an acceptable distribution formula.

Advocates of the grant-in-aid argue that this device secures the same advantage of using the more equitable state taxes for local purposes as does tax sharing, but that payments may be more stable if derived from the general budget. The system does, how-

ever, involve direction of local expenditures and may entail considerable administrative supervision. Since inspection and supervision may easily be made part of the grant-in-aid system, there is a possibility of exchanging information, giving advice, and comparing costs. This item may be very important, especially in highway work where there is always the danger of monopolistic practices on the part of contractors and suppliers of materials, sometimes with the connivance of public officers. The grant may be used for gradual improvement of local administration and may even be used to consolidate local bodies, as in Michigan where the grant-in-aid has been used to compel highway organization in county units. These advantages may be offset by an increase in "red tape," multiplication of jobs, persistent meddling by state officers, and such regimentation of procedure that local officials may lose all incentive and initiative. The administrative advantages and disadvantages, however, may easily be overstressed, for the actual use of the grant-in-aid has not been such as to justify the sanguine expectations of its defenders nor the fears of its opponents. Thus the administrative control exercised by states through school aids for the most part purely nominal; central direction is by statute or mandatory orders. There is more direct control with state aid where attempts at fairly complete equalization of educational conditions are made. In most states the bulk of the highway grants involve no special control beyond that obtaining for local revenues, since the payments are merely made to the county road fund without special limitation. Where the grants come from the state highway department budget there is greater control, as in New York, California, and, to some extent, Illinois. It should be noted that the grant-in-aid as well as tax sharing may serve to perpetuate inefficient local units.

Local organization of American government was a corollary of local taxation, and it can well be argued that with central taxation, the best solution is to transfer the spending functions as well. Governmental structure would be simplified, "red tape" cut, responsibility fixed, and economies made in purchasing and personnel. There are several drawbacks. Few states could finance schools or highways entirely from their taxes without resort to property taxation, so that a transfer would, of necessity, be partial. Secondly, a state bureaucratic administration must work by fairly rigid rules which leave little to the discretion or imagination of subordinate officials. Thus there might be too little recognition of the varying needs of different areas. The tendency in legislation has been largely in the direction of uniformity. There is also considerable danger in the transfer since it gives practically complete control to the faction in power. State civil service is as a whole probably less effective even than that of the cities, where some progress has been made. It is by no means certain that state operation of these ser-

vices would be cheaper, since in New York and Ohio, at least, there have been instances where the counties have built similar roads more cheaply than the state. It may readily be agreed that present local authorities are too numerous and small to be efficient. It is possible that the state would be too large a unit.

As indicated previously, the choice among these alternatives must always involve an element of politics and sheer expediency, or if you will, opinions necessarily based on inadequate data. The experiences of France, Germany, and Italy may somewhat dampen enthusiasm for too much centralization. While local government supervised to a degree under the grant-in-aid system may not be quite as efficient, it would seem that there is something to be said for free trade in politics. The problem is one of striking a proper balance between local initiative and some assurance of a minimum of efficiency. The states could borrow considerable from the federal techniques of project statements, inspection, approval and reports. It seems evident that local officers should not be permitted to use funds raised by general taxation indiscriminately, but there is little reason to believe that all wisdom and honesty reposes in state departments. The frequent use of the federal grant suspension to check dishonesty and inefficiency is some evidence to the contrary.

Robert S. Ford, director, bureau of government, University of Michigan, following Mr. Bittermann, commented on grants-in-aid in the field of education. Referring largely to the Michigan experience, he stated that the grants-in-aid problem became more important during the earlier years of the depression. Although there had been a substantial amount of state aid for education in Michigan for many years, the financing of public schools had been primarily dependent upon the local levies on property. However, during the depression the amount of revenue available for education was reduced greatly because of the high rate of delinquency under the general property tax, and the adoption of the over-all property tax limitation of fifteen mills. With the school problem thrown into the lap of the state, it became necessary to consider a revision in the method of state aid for education. In revising this policy after 1932, several problems arose. First, there was the question of school district consolidation and reorganization. Although very little has been done along this line, the feeling is beginning to develop that state aid should be contingent upon some degree of consolidation among the 6600 independent school districts. Second, what proportion of total school cost should be met by the states and by the local units? As a result of legislation adopted in Michigan since 1933, the state now pays about 53 per cent of the operating costs of the public schools. Third, a state-wide minimum educational program was adopted. The law provided a minimum of forty-eight dollars per year for each elementary school pupil, and sixty-five dollars per

year for each high-school student. If this minimum amount were not provided by the local levies on property and the amount received under the old state aid law, the difference would be paid by the state. This increased aid was made possible by the adoption of the retail sales tax. Finally, an effort has been made to increase the stability and predictability of the amount of grants-in-aid for education. Prior to 1935, the amount of state aid showed considerable annual variation, but under the present law in Michigan it will amount to about 43 million each year.

William Campbell (Michigan) furnished additional details concerning the need and consideration for school district consolidation in Michigan. In one county there was a population of 1,728, with 611 children of school age. All but 140 of the adults were on relief. In another township there was a movement to dissolve the township government. This, however, required five signatures and although there were 13 inhabitants, only 2 of them were voters or citizens qualified to sign the petition. Strangely enough the township required 7 officials to run it. From this, Mr. Campbell concluded that without state aid local governments might learn to do more for themselves.

Frank J. Murray (Indiana) pointed out that the way to block the extension of taxation and services for such functions as welfare, roads and schools, is to stop grants-in-aid entirely.

M. H. Hunter, professor of economics, University of Illinois, responded that if state aid or shared revenues, which make it possible to distribute the greater resources of northern Illinois and metropolitan Chicago to the southern part of the state, were abolished the schools would either have to close down or be so poorly run that they would not be worthy enough to be considered proper public schools. Equalization between one part of a jurisdiction and another is of the essence of government.

Roy G. Blakey, professor of economics, University of Minnesota, was then announced as the next speaker on the program.

WHAT TO SHARE, HOW TO SHARE, AND HOW MUCH

In the matter of grants-in-aid and shared revenues, as in the case of other fiscal problems, it is very difficult to answer questions raised in a satisfactorily specific and helpful way. In the brief time which is at my disposal, about all I can do is make some summary statements of general principles.

I. How to Determine the Percentage of Revenue to be Shared by the Subordinate Units

On the one hand we should determine the relative needs in the way of services of the various subordinate units and of the federal, state or local units, and also what the cost of these services will be, insofar as possible. Such services should be distributed among the different jurisdictions according to relative needs of the units efficiency of administration. On the other hand, insofar as possible each jurisdiction should have allotted to it those specific taxes and other revenues that it can best administer. These decisions will have to be made by the democratic process, which involves education, consideration, debate and compromise decisions. Since it is not likely that cost of services will just equal revenues allotted, those units which have surplus revenues should share them with those having deficits under the arrangements suggested above. If, as is probable, there are insufficient surplus revenues from some units to meet deficits in other units, then the least needed services should be pared and taxes that can be increased most justifiably should be increased enough to reach a balance.

II. Sharing According to Fixed Standards vs. Sharing on the Basis of Logrolling

Sharing should be on the basis of maximum promotion of the general welfare. But since human judgment which is fallible and practically always biased by self-interest is involved, it is almost if not entirely impossible to avoid log-rolling in some degree. A study of how the general welfare can be and has been best promoted, and an attempt to maintain ideals and justice, while they will never attain justice, will, nevertheless, minimize the worst results of log-rolling. We shall never have one hundred percent of justice in taxation or in anything else, but we shall have less justice than the maximum attainable whenever and wherever we relax our efforts to secure it. By the nature of things no hard-and-fast percentage rules can be laid down to cover such varying situations as confront us in the field of grants and shared revenues.

III. From the Standpoint of the Cities and of the States, Which is Preferable, Grants-in-aid or Shared Revenues?

Most units of government and most of the people in them prefer the largest possible measure of autonomy and the largest available sums to spend. But sound finance and the general welfare require compromises, i. e., the democratic process.

Services and functions should be allotted according to relative administrative efficiency, taxes and other revenue sources according to efficiency of the units administering them. To the extent that it

is unwise to reduce services or transfer them to other jurisdictions, or to increase taxes or transfer revenues from one jurisdiction to another, the maintenance of minimum standards of services should be by grants-in-aid insofar as they are feasible. These grants-in-aid usually should maintain services of a reasonable standard. The grants should be used only to make up the difference between the costs of the reasonable standards and what a uniform tax rate by the local unit will raise. In this way we can secure approximately uniform minimum services for the different local units and place upon them uniform tax burdens to support such services through a proper system of state and federal grants-in-aid. Of course, each unit may have additional services above the minimum standard if it is able and willing to pay for them.

Though believing in a limited system of grants-in-aid and believing in the benefits of some such aids which we have had in the past, I am of the opinion that existing abuses will not be remedied soon without the adoption of rather radical reforms. Delicate instruments and delicate methods will no longer suffice. I doubt if those now in power—at the top—will take the action that is demanded by the existing situation. If the situation is not cleaned up, the abuses threaten to undermine our economic and political system. It appears that the remedy for this situation is most likely to grow out of the scandals that will probably come from our present experience. But the worse the cancer becomes before it is cut out, the more dangerous it is to the patient and to the whole economic and political life of the nation.

Carl Shoup, assistant professor of business administration, Columbia University, was not present but the chairman presented his paper, given in summarized version below:

CONDITIONAL VERSUS UNCONDITIONAL GRANTS AND SHARED TAXES

Should certain conditions be attached to the giving of grants-in-aid (subventions) and shared taxes by the states to their local subdivisions? The term "conditions" as I use it here does not include the requirement that the money be spent for some one service. In this respect I follow Professor Newcomer. For purposes of the present discussion the conditional grant includes the zone that extends between ordinary allocation (or earmarking) on the one hand, and, on the other, the highly exact specifications whereby state officials direct on what or on whom each dollar shall be spent.

The conditional great includes instances where the condition refers, not only to the use of the granted money, in which case performance and personnel standards are specified, but also to some

other activity of the locality. Thus the condition may be that the locality raise a certain amount from local taxes, or follow a certain debt policy, or limit total expenditures—and so on.

When the state authorities are given a blanket power of veto over local plans to spend the money, the result may be either ordinary earmarking, or conditioning, or, in effect, state performance of the function — depending on how the state authorities exercise their power.

Those who have made general studies of federal-state-local relations usually recommend that grants or the sharing of taxes be conditional, especially when the sums involved are large compared with the local budget. Thus, when Professor Newcomer, in her "Central and Local Finance in Germany and England," says (p. 302) that "it is unthinkable that a government which is reimbursed for 90 percent of its expenditures by outside authorities should be free to spend at will," the implication seems to be that the control should go beyond mere earmarking among major functions. In his foreword to Luella Gettys' book, "The Administration of Canadian Conditional Grants," Mr. Harris says (p. ix): "One major conclusion from the history of grants-in-aid in Canada is inescapable: it is that weak central administration discredits this device . . . and leads to its abandonment. Those in the United States, or elsewhere, who oppose federal requirements on the states as a condition for receiving federal aid have in Canada an object lesson of the results of such a policy."

On the other hand, strenuous opposition to making grants conditional can be found among those representing the particular interests that will be served by the grants. Thus Professor Mort, in his "Federal Support for Public Education," says (pp. 37, 39): "There is no necessity for setting any conditions, specific or otherwise, for the acceptance of federal aid [for education] under the general plan proposed. . . . It is proposed, therefore, that the only condition to be set for the acceptance of federal aid should be that a full reporting of the use of funds be made to the federal government after the fact."

Two of these quotations deal specifically with federal aid to states. There is, however, a stronger case for control when the grant is from a state to a local subdivision, in the sense that the localities, having no sovereignty, may be expected to submit to whatever degree of control the state imposes (in reality, of course, some meeting of minds of state and local legislators must be presupposed.) Yet the very lack of sovereignty makes on the whole a weaker case for the conditional grant, *as compared with other methods,* in state-local coordination than in federal-state coordination. The state can command its localities; the federal government cannot command the states, but must work its will by indirection. The federal government, desiring to stop "diversion" of state gasoline tax funds,

has to do so indirectly, by adding a condition to the grant of federal highway aid. A state, on the other hand, could pass a law forbidding any locality to divert any given revenue.

The chief question remains: what are the reasons for attaching conditions to grants or shares? A general proposition, herewith submitted for discussion, is that it is first necessary to find the reasons for the grant or share itself, and that these reasons will usually have a direct bearing on the extent to which payment should be made conditional. The following instances will serve to illustrate this thesis:

1. If the grant simply returns to each locality its own money—that is, distribution is on the basis of origin—there seems to be no *special* case for imposing conditions. The grant, to be sure, may be spent to better effect if the state guides the expenditure and insists on certain standards; but this argument may be applied to all of the locality's expenditures. The basic question in this case is, not whether the locality has a right to the grant without conditions, but whether the state wants to supervise local expenditures in general.

2. The grant may be a gift from wealthy sections of the state to poor sections (a gift, of course, that is often expected to benefit the giver in the long run, and that, moreover, may in part be voted to themselves by the donees). Educational grants on an equalizing basis are examples. Here, the argument for attaching conditions may rest simply on the right of a donor to put whatever strings he may wish on his gift. This argument, however, puts too much emphasis on the gift element. After all, the equalizing grant is presumably justified by the good it does for the state as a whole. A stronger argument for attaching conditions to this kind of a grant is that the government of the wealthy community must justify to its own taxpayers the taking of tax money from them year after year to give to the poorer communities. This justifying involves in turn justifying the expenditures the poorer communities make with the money—and it is difficult for the government of the wealthy community to render this accounting to its taxpayers unless it has some control over the spending. Another argument depends partly on the fact that waste in spending may result in leaving so many wants in the poorer communities still unsatisfied that the donors find themselves maneuvered or voted into giving on a much higher level than they ever intended. Both of these last two arguments can cover not only controls designed to get the money spent in a certain way, but also requirements that the locality raise a certain amount of money from its own resources, or reduce other types of expenditure, or follow a certain debt policy, and so on.

3. The grant may be resorted to because the state government disapproves of the local use of a certain kind of tax. The argument for imposing conditions on the grant seems, in this case, less strong

than with the equalizing grants, but stronger than when the state is merely returning the locality's own money to it. Thus the state may ask the locality not to increase the local real estate tax, or to refrain from imposing a special tax on public utilities, or a retail sales tax, in view of unfavorable repercussions on the state's fiscal system. In return, the state gives aid. The bargain is perhaps rarely as direct as this, but the coexistence of property tax rate limits and state aid suggests that in effect this kind of a bargain is often struck.

4. The grant may be purely stimulative, without much concern over any of the forces discussed above. Here, a heavy loading of conditions may so deter the localities as to defeat the stimulative purpose; and stimulation, implying, as it often does, experimentation, may justify some waste, if that is the price to be paid for avoiding a dampening influence of uniform control from above.

In conclusion then, the question of conditions seems to depend largely on the purpose of the grant or share. It also, of course, depends on the soundness of local morale and local administrative techniques.

Harold M. Groves, associate professor of economics, University of Wisconsin, followed Mr. Shoup with the following comments:

THE RELATION BETWEEN THE CENTRAL DISTRIBUTION OF GRANTS-IN-AID OR SHARED TAXES AND LOCAL INDEPENDENCE

The general property tax, although much criticized, has some virtues as a major source of revenue. Not least among these virtues is the fact that this tax is well adapted to a nation imbued with the spirit of local independence and home rule, as opposed to a highly centralized government.

Loss in local financial independence has been due primarily to a revolt against the general property tax in the form of tax delinquency, tax limitation, homestead and industrial exemption, etc. For many years the general property tax was adequate to support both local and state governments. Even though states no longer draw upon the property tax, local units are unable to subsist upon it. Instead of states drawing on the property tax for support, they now must supplement local revenues in order that local governments may enjoy a share of non-property tax receipts.

Most revenue sources alternative to the property tax are not adapted to local administration. Although local governments benefit from these revenue sources indirectly through grants-in-aid or centrally-collected locally-shared taxes, the local unit receives only what the central government permits rather than what it would like or may need. Furthermore, there may be so many strings tied

to the revenue that little or no discretion is permitted the local units in the spending of the revenue.

Analyzing the effect of homestead exemptions, the Division of Research and Statistics of the Oklahoma Tax Commission calls sharply to the attention of the Oklahoma legislature what it has been doing to local independence:

> "The disturbing feature of the picture is the continued reduction in assessments during the past two years, which runs counter to the known increase in values that has occurred since 1934 or 1935. The effect of homestead tax exemption will be to narrow the tax base still more. This downward trend holds a very serious threat to the continued existence of democratic, local self-government. The amount of state aid returned to local governments has increased as the apparent ability of local subdivisions to support themselves has declined. In 1933, \$9,476,265.95 was returned to local governments by the state, in 1937 this has increased to \$31,391,794.27. In the 1938 fiscal year the amount will probably exceed \$40,000,000. Local governments are very rapidly losing their independence by allowing themselves to become servilely dependent upon the state for their financial support." (*Analysis of 1937 Assessed Valuations* (With Effect of Homestead Tax Exemption During the First Year of its Operation), Oklahoma Tax Commission, Division of Research and Statistics, Bulletin No. 29, pp. 11-12.)

The decline of the property tax and of local financial independence has created a municipal problem of inelastic and inflexible revenue. That this is true is suggested by the fact that a considerable number of municipalities have sought and obtained permission to use taxes usually thought to be best adapted to state and federal use. Thus we have a few municipalities with their own gasoline, motor vehicle license, net income, or sales taxes.

If the local units of government are to surrender their independence they should expect a better tax system, at least, in return. The property tax has a great many limitations as a major source of public revenue, but it is, to say the least, highly doubtful if the retail sales tax represents any improvement.

If municipalities are to depend in considerable measure upon centrally collected taxes for support, the question arises as to the degree of control over local expenditure of this "state money" which the state should exert. Distribution without "strings attached" has usually accompanied centrally-collected locally-shared taxes as distinguished from grants-in-aid. The difference is only one of degree, since even the continued existence of central-collection and local-sharing depends upon the will of the central government. The prevailing opinion among the experts seems to be that if the muni-

cipalities are to subsist on state funds, the state should have more control over money spent. It is impossible not to sympathize with this view. But at the same time the interest in local independence is entitled to some consideration.

Perhaps there is a difference between the positive controls and the negative ones. It may be one thing to safeguard against abuse and another to dictate in detail the precise use of funds. Perhaps what is needed is more vigorous negative controls and less interference of a positive character. However, there is doubt as to whether the two in practice can be separated.

There is no great gain without some small loss. The outlook for local independence in view of the financial trends is not a very bright one. Unfortunately, this very considerable loss has not in many cases been balanced by any important gain for the tax system.

Henry F. Long, Massachusetts commissioner of corporations and taxation, next commented on the problem of grants-in-aid and shared revenues in relation to the future of American government generally. He pointed out that policy with respect to such grants and sharing of revenues is likely to be influenced by considerations of political expediency as well as by a pragmatic tendency on the part of the administrative branch of government.

When grants-in-aid and shared revenues had their inception in this country the present nomenclature had not been developed and their use was employed solely to satisfy the common-sense needs of the time. As a matter of fact in origin shared revenues emanated not from the conclusion that the state should share its revenues with the localities but in a manner which was just the reverse. In Massachusetts, communities were assessing ad valorem taxes before the state took advantage of its superior right to take from these communities a share of the taxes so raised. The income tax in Massachusetts is a form of reaching certain types of intangible wealth, the revenue from these sources also originally lying in the hands of the local communities as a property tax.

In the future, no doubt, factors will play a part in the development of policies with respect to grants-in-aid and shared revenues in this country which in earlier days received little or no recognition. Among these factors may be the following:

1. Ease of administration.

2. The competition between the developing philosophy of national plans of social and economic action and the previously existing philosophy of meeting public needs through local agencies. In this connection security, highway and similar programs are presently playing a significant part.

3. Trends in the direction of nationalization. The very powers which the states have absorbed from the local units of government

may in turn and to an extent be taken from the states by the federal government.

In the last analysis, however, those who have faith in democracy should hope that to the extent these devices are employed in a sinister manner to divert revenues arbitrarily or unreasonably from one section of the nation to another or to take from one class and give to another unfairly or to such degree as to discourage industry and enterprise they will ultimately break down, and that only as these methods are adopted as a means to benefit the people of our country as a whole will they survive.

HAROLD SMITH, the chairman, ended the session with a plea for more flexibility in preserving the autonomy of the state governments in their dealings with the federal government under the developing system of grants-in-aid.

ROUND TABLE VI

IMPROVING TAX COLLECTION PROCEDURE

Presiding Officer

CARL CHATTERS, Executive Director, Municipal Finance Officers' Association, Chicago.

Recording Secretary

PAUL E. MALONE, Associate Professor of Business Administration, Miami University.

Opening remarks and basis for discussion by Paul E. Malone.

Participants:

FREDERICK L. BIRD, Director of Municipal Research, Dun and Bradstreet Inc.

DONALD JACKSON, Senior Agricultural Economist, Bureau of Agricultural Economics, Washington, D. C.

ALBERT E. COBO, City Treasurer, Detroit.

J. A. SCOTT, Assessor, City of Duluth.

EDWARD J. GARDNER, Chairman, Delinquent Tax Commission, Ohio.

LEO DAY WOODWORTH, Chief of Research Staff, Michigan Tax Study Commission.

P. A. HERBERT, Professor of Forestry, Michigan State College.

H. K. ALLEN, Professor of Economics, University of Illinois.

RICHARD W. NELSON, Senior Taxation Economist, U. S. Forestry Service.

GEORGE O. FAIRWEATHER, Chairman, Citizens' Committee on Tax Collections.

DOUGLAS SUTHERLAND, Executive Secretary, Civic Federation and Bureau of Public Efficiency.

G. A. LOOMAN, County Treasurer, Cass County, Illinois.

RECORDING SECRETARY: However great the losses associated with a time of national stringency may be, such periods are not wholly without compensatory gain. The heat of social stress thus generated does at least partially consume the dross which through long years has barnacled itself to important economic and social mechanisms. The effectiveness of this refining process has nowhere been more marked than in the field of property tax administration. Everyone recognizes that the failure of this instrument has been due in part to the unfavorable conditions under which it has been required to operate. Equally clear is the evidence that unsatisfactory performance has been attributable in no small measure to administrative laxities.

It was in an examination of these latter characteristics that the round table discussion here reported was especially significant. Those participating in the discussion were generally in agreement that of the several moves that might be decided upon to make the property tax function as a vehicle for raising public revenues, none offered greater promise than those directed toward the correction of administrative defects.

Carl Chatters, executive director of the Municipal Finance Officers' Association, and chairman of the round table, indicated clearly in his opening remarks that the discussion should be limited to the procedural aspects of property tax delinquency. Matters pertaining to billing and follow-up; publicity; tax collection campaigns, including notices, meetings, and legal enforcement, were suggested as items falling within the range of subject matter contemplated by the program committee.

Certainly the element basic to progress in the field of property tax administration is that of more accurate, comprehensive, and inclusive data pertaining to assessed valuations, levies, collections, debts, and expenditures of state and local governments. C. E. Rightor, chief statistician, division of statistics of states and cities, explained in some detail the efforts being made by the bureau of the census to supply administrators and students of government with data essential for advancing the cause of efficient government and community betterment generally. Through the adoption of a resolution, those in attendance at the round table expressed their belief

that the efforts of the bureau of the census should be extended in the assembling of financial statistics. The resolution adopted by the round table section and formally approved by the conference reads as follows:

> RESOLVED, That the National Tax Association recognize the need for more adequate financial statistics dealing with states and local governments, and urge the bureau of the census through its division of financial statistics of cities to make every possible effort to expand the scope and coverage of the work it is now doing in the compilation of statistics of states and statistics of cities.[1]

Frederick L. Bird, director of municipal research, Dunn and Bradstreet Inc., presented a very interesting account of the behavior of municipal tax delinquency during the depression years of 1930 and 1933, as compared with 1937 and 1938. Information gathered for 150 cities showed a median delinquency of 10.2 per cent in 1930; 26.4 per cent in 1933; and 11.3 per cent for 1937. Forty-six of the 150 cities had a better record in 1937 than in 1930. This improvement was due to changes in the system of tax collection, altering the fiscal year to correspond with the tax year, making provision for installment payments, and pursuing a policy of more rigorous enforcement.

Median tax collections for 1938 are running one per cent better than last year. The range of experience is rather narrow, running from 3 per cent lower to 3 per cent higher. Those cities ranking low in cyclical stability are exhibiting the most favorable records. This condition is apparently due to improved administrative practices.

The trend and present status of rural tax delinquency was discussed by Donald Jackson. Mr. Jackson's remarks are supplied in full.

TRENDS AND PRESENT STATUS OF RURAL TAX DELINQUENCY

DONALD JACKSON
Senior Agricultural Economist

In considering the rural tax delinquency situation I shall restrict my remarks principally to real estate delinquency on agricultural property. Obviously there is other important rural tax delinquency. The most important class closely related to that of agricultural property is the delinquency of forest cut-over lands. To a considerable extent agricultural and forest real estate is favorably or adversely

[1] Introduced by Carl Chatters, motion for adoption made by Albert Cobo of Detroit, seconded by Edward J. Gardner of Ohio.

affected by the same tax measures or characteristics. The U. S. Bureau of Agricultural Economics and the United States Forest Service have come to appreciate more and more in recent years the similarity of tax problems on agricultural and forest lands.

To hold the subject in still closer bounds, I shall omit further reference to rural special assessment problems, such as those of irrigation projects.

The trend of rural tax delinquency can neither be exactly stated nor simply appraised. Statistics for the country as a whole are not available on a uniform basis. In 1934, nation-wide surveys were made of both rural and urban real estate tax delinquency. While they both obtained valuable information the period covered was short, and they could not present the complete situation. In recent years, principally since 1930, some of the state governments have been making such segregations of data on collections as to give excellent indications of the extent of delinquency.

How much of a cycle existed in rural delinquency before the World War cannot be stated. That there was no significant trend can be stated with fair assurance. Alabama, for example, had acute delinquency troubles in its early years of statehood. But that was the special case of a new government struggling to write workable laws and enforce them; it took time. The upper Lake States appear to have had increasing rural delinquency after perhaps 1910, but this was another special case. The difficulty arose in cut-over areas where assessment failed to take into account the fact that much real estate was losing nearly its entire value through deforestation.

Through the decade of the 1920's, the trend of rural delinquency appears confused. Many agricultural counties were sustaining excellent collection records; others were experiencing difficulty.

In this characterization, reference is to the relation of total tax collections to levies. The year-to-year story of short-term delinquency may be quite different. The records of some agricultural counties in California show collections of more than 100 per cent of levies in nearly every year since 1918, and in no year show any great deficiency. To some farmers of those counties the inability to meet all tax bills on time has been a costly experience; to the local fiscal systems such delinquency as a whole has brought greater revenue than was levied.

Regarding the trend through the distress years 1929 to 1933 the survey of rural delinquency which the bureau of agricultural economics administered for the Federal Civil Works Administration gives a good basis for judgment.

Detailed summaries from that survey covered about 650 agricultural counties in the 48 states. Data were taken from the official records for the levy years of 1928 through 1932. The period covered essentially the complete development of farm tax delinquency

into an extraordinary problem. Before 1928 all delinquency was principally a matter of special cases; after 1932 the difficulty began to mend both from its fiscal and from its private cost aspects.

In 1928 something less than 12 per cent of the area of the counties surveyed was tax delinquent. This figure may sound large, but by 1932 it had increased to 28 per cent. Principal significance attaches to the increase of 240 per cent. Both figures include short-term delinquency. Such delinquency is important enough from many angles, but does not greatly elucidate the chronic problem which was developing.

Amount of delinquency increased about with the area increase. The two trends differed in many counties or states, but the difference largely averaged out. Figures from the sample suggest by rough calculation that about 475 million individual acres of land were delinquent within the five-year period, for the sum of perhaps 550 millions of dollars in taxes. Relative size of the acreage and dollar figures must not be used to indicate rate of taxation; some acres were delinquent for several years' taxes, some were delinquent for a fraction of one year's levy. The dollar delinquency was of a magnitude somewhat comparable with the 1932 property tax levy against farmers, but must of course be spread over all rural taxes, rather than farm taxes only.

From the standpoint of the tax student and tax official an interesting characteristic of the series for various states is their similarity. Rates of increase naturally varied, but no state had such moderate taxes or such an efficient collection system as to prevent a very great and dangerous increase in rural real estate tax delinquency.

Disposal of delinquency once it had occurred may appear at first glance to indicate too lenient a collection policy. Only 35 per cent of the acres found delinquent had certificates sold against them at the time the survey was made (early 1934). Only one-fifth of the acres covered by certificates had tax deeds recorded against them. Further thought, however, should modify the impression by relating it to the farmers' situation of the time. Farm real estate values against which the taxes were levied dropped 36 per cent, on the average, for the country from 1930 to 1933. The corresponding tax drop was 22 per cent. Gross farm income dropped 55 per cent. In response to this drop in income the farmer's fixed charges on debts and taxes, and his more flexible living costs, all had to give ground, but they all complied with reluctance and delay. Obviously extensive delinquency was an important part of the process.

The basic and vital effect of private income changes is again seen in the fact that by 1934 one-half of the delinquency of the period 1928-32 had been paid, and 40 per cent of the delinquent acreage cleared. For additional credit to the taxpayer, though of no

direct benefit to the taxing jurisdiction, 30 per cent of the properties sold had been redeemed.

From the depths of the depression forward farmer financing by federal agencies assisted directly and indirectly in paying both current and delinquent taxes. From May, 1933 to December 31, 1936 over $60,000,000 in taxes was refinanced by the Federal Land Banks and the land bank commissioner. Other financing and refinancing led indirectly to the same result.

Placing the turning point in the rural delinquency situation depends upon the characteristics selected to represent it. Number and amount of new delinquencies (on properties not before delinquent) changed approximately with agricultural income. Such delinquency probably reached its crest with the levies of 1932 or 1933. Total delinquency continued to increase, however, for a year or two longer. The curve for collections of delinquencies lags still further. Taking Iowa as an example and using state totals for convenience, collections on delinquencies as percentages of current levies approximated roughly: 1 per cent in each year from 1928 to 1931, inclusive, 2 per cent in 1932, 5 per cent in 1933, 15 per cent in 1934 and 12 per cent in 1935. Returning for a moment to the fiscal matter of total collections in relation to levies, the only two years showing great deficiency in Iowa are 1932 and 1933 when collections were 93 per cent and 91 per cent of current levies; for the succeeding two years they were 104 per cent and 105 per cent.

The current farm delinquency situation appears to be that as a whole farmers' property tax payments are at least equal to current levies, probably greater. In many farm communities collections are *decidedly* greater than levies. No attempt has been made to obtain a representative sample, but here and there figures are reported for single counties showing the excess collections to be as much as 10 or 15 per cent.

This of course means that for such communities our bureau series of farm real estate tax levies do not properly represent the trend of increasing farm tax payments. An adjustment for delinquency and delinquency payments—such an adjustment as the bureau hopes to make in the near future—will show the amounts which farmers paid in real estate taxes to have fallen off in the depression much more than shown for levies. Since then the trend of payments will be found to be upward and at present to be increasing faster than are the current levies.

Appraisal of the farm tax delinquency problem of necessity depends largely upon adequately recognizing and emphasizing several significant aspects of the phenomena. If all property owners pay their taxes when due, the taxing jurisdiction obviously collects exactly 100 per cent of its levies, allowance of course being made for collection commissions. If one-fourth of the property owners regularly paid their taxes one year late, they normally would pay more

than the amount levied. The taxing jurisdiction would collect less than its levies in the first year, but thereafter would obtain each year something above 100 per cent of its current levy. The severe difficulty really arises in the fact that wide fluctuations in the extent of delinquency from year to year or from period to period, leaves the jurisdiction with only undependable revenue.

The difference in significance of delinquency from the standpoint of the taxpayer and that of the taxing jurisdiction still is too often confused in spite of the extensive attention which has been devoted to the subject. The cost of short-term delinquency usually falls on the taxpayer, but in the case of abatement, rebates, or bargain settlements, it is shifted in all or in part to the taxing jurisdiction. A few of the states have regular arrangements by which abatements or rebates may be given in case of distress. This arrangement appears to me to recognize that in a specific case the application of the tax process may go awry. Someone's judgment, or just possibly his intention, is bad. When special arrangements are made for bargain settlements on a wide scale, at a given time, however, it suggests that the system, rather than some one's judgment in an individual case, is at fault.

There are several possibilities: the adjustments may be unjustified because unnecessary economically. This in turn means one of two things. Either the delinquency was voluntary, or if necessary, it was due to temporary economic difficulties and could have been paid eventually. The adjustments, on the other hand, may have been necessary or socially desirable either because assessment was too high or because the temporary economic difficulty was too severe for the financial reserves of a large fraction of the taxpayers to bear.

When delinquency becomes widely prevalent in one class of real estate in a jurisdiction it is prima facie evidence that that class of property is over-assessed, and this has been the case with a large part of the rural delinquency of the past few years. Only the lower-value lands have become delinquent. In fact this has for years, possibly always, been so prevalent an occurrence that most of us have come to accept it as the natural order of things. We know that one study after another has shown assessments on acreage properties to be regressive both on area and on value per acre. That tax delinquency on the lower value lands is to such a wide extent long-term or permanent substantiates the view that these lands have been accorded essentially different treatment from that given the higher-valued properties.

Looking forward rather than backward, what of the amount of farm delinquency, what of its determinants? The amount of short-term delinquency at the present time can scarcely be called abnormal. Long-term delinquency on lands of low or nominal value undoubtedly is large where owners have come to realize the futility of paying taxes on assessments beyond the fondest hopes of realiza-

tion. In such position the owner has no alternative; and the taxing jurisdiction has no alternative, except the one it has persistently declined to use—that of adjusting assessments to real values.

In other words, there appears to be relatively little in the farm tax delinquency situation which can be corrected by changing the collection procedure or penalty and interest rates. Installment payments are a delusion in many commercial farming areas, shortening of redemption periods will in distressed times be disregarded locally or will endanger other orderly processes, segregation of intangibles and tangible personalty may benefit owners of such property; but the major part of farm tax delinquency must in honesty be adjudged "necessary" under conditions which obtain; when corrected, the correction will be by changes which reach deeper and are more basic than collection procedure.

Recording Secretary: Albert E. Cobo, city treasurer, Detroit, gave a very lucid account of the difficulties his city has encountered in extricating itself from the morass of accumulated delinquencies. On June 30, 1933 Detroit's outstanding taxes, including special assessments, amounted to $72,296,776, an amount approximately equal to the budgetary requirement for a year's operations. The table below shows how this condition had been developing since the year 1925.

Year	Budget	Amount Collected	Percentage
1925	$56,209,482.35	$53,329,284.19	95%
1926	71,318,645.62	66,849,061.60	94%
1927	76,030,836.19	69,825,304.02	92%
1928	76,573,387.20	69,696,712.62	91%
1929	76,050,654.21	67,646,707.54	89%
1930	76,071,755.84	62,829,533.97	83%
1931	76,029,513.26	59,126,195.21	78%
1932	72,632,990.81	47,294,762.92	65%

To meet this situation Detroit set out to improve its tax collection procedure by making changes in its laws, tax accounting procedure, and by setting up a new statistical record card. Under the old law, taxes were sold to tax title buyers at the close of the fiscal year. The tax title buyer upon request was given a 99-year lease on the property two years and six months after the purchase date. Taxes not purchased by outside buyers were bid in by the city. Although interest was accumulating, the city had no right of action of any kind. The new law provided that all unpaid taxes shall be bid in by the city at the close of the fiscal year. The city can, on request, obtain a deed by court order two years and six months after the date of purchase.

The tax accounting procedure was changed from the old bound tax books to unit cards. A card was set up for each property description showing the total tax delinquency by kind of tax, year incurred and a grand total of all taxes due. A new statistical card record was set up from the unit cards. These statistical cards show the amount of taxes due by class of property—hotels, apartments, commercial, industrial, two flats, single homes and vacant lots. These classifications provide the basis for collection campaigns used in making the provisions of the new law effective. Each classification is worked separately, thus insuring effective coverage and equitable treatment.

An example of how this statistical record has been applied to collection procedures may be cited in the case of hotels and apartments. One thousand, five hundred and four delinquent hotels and apartments were listed for action. Of the 1,504 all but 590 paid their taxes before letters were completed for mailing. Of the 590, all but 59 have since either paid their taxes in full or are now paying on an installment plan. Foreclosure proceedings have been initiated in all those cases where no provision for settlement has been made. As a result of this special effort $4,102,000 was collected from these two classifications since the time the list was prepared for special attention.

Evidence of the effect of the improved collection procedure may be seen in collection figures covering the years subsequent to 1933. The table below indicates that in this period the percentage of levy collected grew from 68 to 88 per cent.

Year	Budget	Amount Collected	Percentage
1933	$55,655,836.32	$38,226,134.38	68%
1934	55,512,998.37	41,373,923.28	74%
1935	54,846,916.30	44,472,948.38	80%
1936	54,827,743.34	47,232,052.33	86%
1937	59,280,482.00	52,166,824.16 Estimated	88%

The factors making possible a $26,000,000 reduction in the total amount of taxes outstanding are due in no small measure to adoption of the following measures:

1. Refunding city indebtedness so as to spread the payments over a 30-year period.
2. Lowering current tax budgets, from $76,000,000 to $55,500,000.
3. Giving seven years, or 14 semi-annual payments, in which to pay off delinquent taxes for 1932 and prior years. Eighty thousand parcels filed under this plan, representing tax arrears of $23,500,000.
4. Interest charges were decreased from 10 per cent a year to 7 per cent the first year, and 8 per cent thereafter.

5. Abandoning the sale of taxes to outside buyers except at the discretion of the treasurer and the council.

6. Permitting parties of interest or equity to buy their own tax certificates, by paying all previous taxes in full, plus a flat 5 per cent penalty. Twelve million dollars was collected under this plan last year and $7,000,000 so far this year. Thirty-six thousand parcels paid their obligations last year and 20,000 so far this year.

7. Permitting the city to obtain a deed two years after the close of the current year, or three years after the tax has been levied. (It takes six months in court to obtain this deed.)

8. Seventy-seven thousand dollars was devoted to a campaign, comprising newspaper, radio station, and billboard advertising. Thousands of pamphlets distributed through the schools, trust companies, banks, etc. were used to advise the people of their rights under the various tax plans, and to explain to them that every dollar paid would help to keep the next tax bill that much lower.

9. Reorganization of accounting system so as to permit collection campaigns by types of property, and to provide complete and accurate information as to the tax status of individual properties.

John Witherspoon, assistant corporation counsel for the city of Detroit, who was primarily responsible for drafting the revised law for handling delinquent properties, gave more detail regarding the legal revisions. He said:

"In October, 1933 the tax provisions of the charter of the city of Detroit were amended to provide for a new method of sale and foreclosure for the collection of real estate taxes. The new procedure became effective with the sale of delinquent 1933 general city real estate taxes held in June, 1934 when the unpaid tax lien was offered for sale. All of the liens offered that were not purchased by private purchasers were sold to the city of Detroit by bid of the controller.

"The charter was again amended in October, 1935 to provide that all unpaid tax liens offered at the annual sale held each year for delinquent real estate taxes shall be sold to the city of Detroit by bid of the controller except those parcels offered for sale at public auction to the highest bidder as provided by resolution of the common council. The council has not authorized any sales to private tax title purchasers, therefore all of the unpaid tax liens at the present time are bid in by the city of Detroit.

"The charter, as amended, provides that the city has the same right to foreclose as a private purchaser.

"The new procedure authorizes a foreclosure of the tax lien by a bill in chancery, which can be filed two years from and after the time of the sale. All of the parties having an undischarged recorded interest in the real estate, as well as persons in possession, are sum-

moned into court by personal service, or service by publication, of a summons and the bill of complaint.

"The charter[1] provided that a decree of foreclosure cannot be requested until 120 days have elapsed from and after the filing of the bill of complaint. The decree vests title in the owner of the tax lien, if the amount of such decree is not paid in full within 60 days from the date thereof.

"This foreclosure proceeding is, in effect, a suit to quiet title and does, we believe, result in good title to the property."

[1] *Charter of the City of Detroit*, Section 18, Chapter IV, Title VI.

Should such tax lien and liability be still unpaid two years succeeding the date of its sale, the holder thereof (including the city of Detroit acting by its controller), in addition to such other remedies as may exist or be given by law, shall have the right, then or at any time thereafter, to file in the circuit court of Wayne County a bill in chancery to foreclose same. The holder of several tax liens on the same or different parcels of real estate may file a single bill in chancery to foreclose the liens on the parcel or several parcels of real estate subject thereto. Such bill and the procedure thereon shall conform to the law in respect to foreclosure in chancery of liens on real estate other than mortgage or other liens having special statutory provisions applicable thereto. Costs, including attorney fees, against either party may be fixed in the bill in chancery to foreclose the liens on the several parcels of real estate subject thereto. Upon the filing of such bill the court shall issue summons or other process for appearance as in other chancery cases or in lieu thereof either or both may make and enter an order for appearance against all defendants or several orders for appearances against different groups of defendants arranged as may be convenient and such order or orders shall be published or served (if there shall be more than one order one or more may be served and one or more published), as provided by law in case of absent defendants and if published a copy thereof shall in addition be sent by registered mail with the postage thereon fully prepaid to the last known address of the person or persons appearing by the records in the office of the register of deeds of the County of Wayne to be the latest grantee or grantees in the regular chain of title of such lands or of any interest therein at the date of the filing of such bill of complaint and to the person or persons, if any there be, in the actual open possession of such parcel of land at the date aforesaid, and to the holder of record of any tax lien for the latest year's taxes then appearing of record in the office of the city treasurer or latest deed conveying title derived from such tax lien appearing of record in the office of the register of deeds and to the mortgagee or mortgagees named in all undischarged recorded mortgages or to any assignee or assignees thereof of record at the date aforesaid and to the holder or record of all undischarged record liens. The decree in such suit, if in favor of the holder of the tax lien, shall provide that possession of the premises subject thereto shall forthwith be given to him, unless the amount of the decree and all costs be paid within sixty days from its date, and shall award to the plaintiff a writ of assistance and any other process requisite to obtain possession. The decree shall not be entered before the expiration of one hundred and twenty days from the filing of the bill. There shall be no redemption period under such decree beyond said sixty days. Appeal may be taken on such decree in the same manner as an appeal is taken in other chancery cases, but an appeal as to the lien on any parcel or by any defendant shall not affect the proceedings on any other parcel or defendant as to which there has been no appeal. The decree, if in favor of the

RECORDING SECRETARY: The remarks of J. A. Scott, assessor, city of Duluth, regarding the experience of Duluth with respect to foreclosure proceedings, are quoted in full.

"Prior to the legislative session of the state of Minnesota for the year 1927, there was no law under which the state could take over delinquent properties. In that year a law was passed whereby the property could be taken over by the state or by an individual making purchase of the property five years from the date of the sale without any further civil process whatsoever.

"No one attempted to claim title under its provisions. The legislature in their session of 1929 and 1931, passed similar laws, with slightly greater restrictions. Not until the year 1935 was a law passed whereby the properties would be taken over by the state upon notice of such forfeiture printed once a week for three successive years, in some legal paper within the county and calling attention to the posted notice on file in the county auditor's office; service upon the occupants to be made by the sheriff's office and return thereof filed with the county auditor. This was patterned after the Michigan law and which law was declared unconstitutional on the part of the supreme court of that state.

"The properties under this law, and being chapter 278, laws of 1935, were taken over by the various counties, a year from date that the sheriff had filed his notice of service upon the parties in occupancy and a year from period that affidavit of publication of notice was filed in the auditor's office.

"The legislature in session in the year 1937 dealt leniently with delinquent taxpayers and provided that the property could be repurchased by the owner for a certain period of time and which

plaintiff and if it is not paid within said sixty days and if there is no appeal, shall be conclusive as to the title and right of possession of the plaintiff, and shall direct the controller to execute and deliver a deed in appropriate form to the plaintiff which shall vest in the plaintiff absolute title in fee as against all persons claiming estate or interest whether arising or existing prior to the time such tax first became a lien or subsequent thereto: Provided, that any state or county taxes or assessments that have been bid to the state or remain unpaid in the office of the auditor-general or county treasurer whether the lien for such taxes or assessments became a lien prior to or subsequent to the tax lien under foreclosure, estates or interests arising from taxes or assessments becoming a lien subsequent to the lien under foreclosure on the property described in such deed, and any restrictions in respect of building or use in common with other property in the immediate neighborhood, shall not be affected by such sale foreclosure and deed.

If the court in such procedure to foreclose the tax or assessment lien shall find or if appeal is taken and it is determined that the sale of the same to the purchaser (other than the city of Detroit by bid of the controller), was void, the city of Detroit shall refund to the purchaser thereof the amount of his bid together with interest thereon at the rate of five per cent. per annum. (As amended Oct. 10, 1933. In effect Oct. 16, 1933.)

period expired in most instances about February 28, 1938, at sixty cents on the dollar. They also passed a law providing further that they could settle this account on the ten year payment plan. In addition, they passed another law whereby an owner of delinquent lands could repossess himself under the confession of judgment law, by applying for settlement on the ten year payment plan basis, paying 1/10 down, the balance in nine annual installments with interest at 4% per annum. Under this contract also agreeing to pay current from year to year while the contract was in force.

"The validity of this law was attacked in the 15th judicial district of this state and, upon hearing the court held the law invalid and that the state's interest therein, due to defective notice of expiration of redemption, was only that of the lien for taxes.

"We understand that an appeal from the decision of the district court is to be taken to the supreme court of the state. It is quite apparent, if the supreme court sustains the district court, that a new legislative enactment will have to be passed; a law so worded to afford no short cut to the medium sought, based upon the feeling that the state, in order to possess title, must proceed in the same way as any one else in civil proceedings."

Recording Secretary: Edward J. Gardner, chairman, Delinquent Tax Commission of Ohio, reviewed for the round table the delinquency situation in Ohio and the work of his commission. The full text of his remarks is given below.

The delinquent tax commission of Ohio has now completed all of the public hearings which were held for a determination of the causes contributing to the accumulation of delinquencies in the 88 counties of Ohio. Hearings were held in six communities: Akron, Cincinnati, Columbus, Cleveland, Dayton and Toledo, and two questionnaires were mailed: one in 1937 and one in 1938. These questionnaires were sent to the prosecutors, the treasurers and the auditors of each of the 88 counties. Out of this mass of material four causes for present delinquencies have been discovered. They are: (1) economic conditions affecting specific urban areas, (2) excessive special assessments, (3) laxity in administrative practices in treasurer's offices, and (4) statutory and legislation inadequacies regarding foreclosure and forfeiture.

The relative weight given to each of these general causes depends entirely upon the locality in which the hearing was held. Toledo, Cincinnati, and Dayton and Columbus in some degree attributed the cause to the excessive special assessment. Various suggestions were offered for improvement in collection methods. Some of the more important are as follows: deeds should not be accepted for recording until taxes and assessments are paid in full; partial payment of current taxes should be permitted; arrangement should be made

for graduated penalties rather than straight 10 per cent penalties; provision for a discount as an inducement for prompt payment instead of penalties; establishment of a special department to enforce collection; appointment of receivers for all properties producing income; advertising delinquencies by the treasurer; and modernization accounting methods and equipment.

Any person who devotes careful study to the delinquent tax problem in Ohio cannot avoid the conclusion that a great deal of the existing tax delinquency is attributable to a lack of respect, on the part of the taxpayers as a group, for the agencies which administer our local governments. No particular office-holder and no particular agency of local government can be held wholly, or in a large part, responsible for this attitude. The abuses of special assessment privilege has led to such inequities in the burden on real property in the state of Ohio that there is small wonder that the citizens and owners of real estate are now proposing that real estate be exempt from all share in the cost of government in Ohio. The fact that none, or no single agency, can be held responsible in the present county governments for the breakdown in confidence on the part of the taxpayer, is the essential cause of our difficulties. The avoidance of responsibility has become an art which is easily and quickly mastered by the office-holder, however sincere he might be. In fact, this art of avoiding responsibility *must* be mastered by each particular office-holder under our present system of administering local governments. The system demands it.

Since it is utterly futile to place the blame for a sad state of affairs, such as the delinquent tax situation in Ohio, upon the holders of any specific office, or upon the taxpayers themselves, or upon the general electorate, a constructive point of view demands an answer to the question, what can be done about it?

The answer lies in the creation of a system wherein someone can be held responsible for the efficient and complete administration of local finances. There is no solution to the delinquent tax problems, or to the larger problems of efficiency in the administration of local governments, except in these terms.

The delinquent tax commission, in order to develop an answer that will effectively eliminate some of the abuses in real property assessment and collection of taxes, has agreed to develop two programs at this time. The first program will be to determine what things can be done to the existing real property laws of Ohio that will effectively correct the more outstanding abuses that have grown up in their administration during the past twenty years. The second program will be a long-range program that will seek to develop a more equitable system of real property taxation and control of local government finances. I will discuss the second program briefly at this time and devote the larger portion of my talk to the more immediate program of essential changes in the present laws because

we are faced with the need for prompt cooperation on the part of the local officials in order to provide some machinery which can immediately be used for the liquidation of present excessive delinquencies.

It will be necessary in the long-range program to establish definite statutory procedures and provide certain definite and assured penalties for the office-holder who fails to follow legal requirements. The law must provide for the following: (1) Establishment of standards for the appraiser of urban real estate and rural real estate; (2) appraisals, when made on the basis of these standards, should be kept up to date currently by a county appraisal department; and (3) no public credit should ever be used for private enterprise. This means that no improvements on real estate subdivisions should ever be financed by special assessment bonds upon which the credit of the entire community is pledged. The bond should either be sold upon the weight of the land involved in the development, or the development should be made gradually as the promoter can finance the project himself.

The billing of taxes should be made on a monthly basis. The collection should be centralized in a local finance office and distribution made in the same office. The entire program of revising the real property tax law in Ohio here contemplated rests on the assumption that a department or bureau of local finances will be created in the state of Ohio and that this bureau will select in cooperation with the state civil service commission, a panel of persons qualified to hold the office of director of finance. Also that the county commissioners in each county of the state will select a director of finance from the panel of persons designated by the state bureau of local finances as qualified to hold this office.

In general, the county director of finance shall not only assume full responsibility for the administration of finances in the county, but all cities, villages, townships and school districts as well. As his title implies, he shall be strictly an administrative officer carrying out the duties placed upon him, which duties must, of course, be carefully defined.

The program covering the more immediate recommendations will now be considered. It is proposed that whenever a parcel of property is in arrears two semi-annual payments, that property is to be placed on the delinquent tax list or certified to the delinquent tax collection department of the treasurer's office. The delinquent tax collection department, which will be organized under mandatory statute, will be empowered to offer a partial payment contract similar to the Whittemore contract, or a monthly payment plan, or a tax certificate title lien note. The delinquent tax collection department would have six months in which to place all parcels shown delinquent at the close of the last semi-annual payment under one of the

three alternative plans mentioned above. Upon the lapsing of six months from the date of certification to the delinquent tax department, that department must certify to the prosecutor for tax foreclosure after the property owners fail to pay or enter into a contract under one of the three alternative plans.

If the taxpayer has complained in respect to an excessive assessment, he will request a review by application to the county board with an appeal from their determination to the common pleas court. Such appeal shall count as a respite of tax foreclosure until the time of the revision. However, this complaint would of necessity have to be filed within the six months' period that the account is in the hands of the delinquent tax department for handling. When the property is certified to the prosecutor for tax foreclosure it will be provided that the foreclosure procedure will be simple; only one advertisement will be necessary and that is the advertisement of the sale. This advertisement may refer to tract and lot number and street address and need not set forth a legal description of the property. The commissioner of the county will be authorized to appoint employees to facilitate the handling of tax foreclosure cases. Summons may be mailed to the last known address, if not personally served, or if publication is necessary, notice may be given as in divorce cases, and advertising need not contain legal description of the property. Once tax foreclosure is started property owners may not avail themselves of any of the partial payment plans mentioned above. If no particular bidder appears at the foreclosure sale or bids are insufficient in amount to cover the tax and assessments then due, the county would be presumed to have an automatic bid for the taxes and assessments, and that land would be sold to the county for its claim.

Once the property gets into the hands of the county provision will of necessity be made for this land to be handled by a real estate bureau within the county and to be sold through the real estate bureau or through other licensed real estate agencies at its true market value which should be determined by the appraisal board to be composed of representatives of all subdivisions having an interest in the delinquent taxes. The county would give to the various taxing subdivisions certificates of interest in the property so held, stating thereon the percentage of interest which they held and the division of the profits of sales to be made to the local taxing subdivisions as the sales are made and collections received, at which time the local taxing subdivisions would surrender their certificates of interest. This program would call for the re-enactment of the Whittemore act or some similar partial payment plan, enactment of a tax certificate lien statute, and simplification of the foreclosure procedure in order to accomplish the results outlined above. The immediate program also includes a recommendation that the deed may not be recorded until the delinquent taxes and assessments have

been paid. It is recommended that the foreclosure act of the general code be appended to provide for immediate starting of foreclosure at the expiration of six months following the period at which the property is delinquent for two semi-annual payments; and, that such foreclosure suits be filed by the prosecutor within a short period following the advertisement of the foreclosure list. This will shorten the time involved in foreclosure procedure from the present seven-year period to less than three years. The auditor of state will be relieved of any duties in connection with foreclosure and the entire process will be put in the hands of the local county officials.

It is recommended that the practice of advertising long lists of delinquents be discontinued. Billing and contacting by the collecting officials will serve as sufficient notice to delinquent property holders. The notice of final foreclosure by the county representative will be adequate after the previous efforts at collection. Simplification of the procedure will cut the cost of foreclosure to a minimum. It will enable titles to property purchases at foreclosure sale to be passed to buyers with no strings or comebacks attached.

The right to sell foreclosed parcels should be a continuous one, not just a yearly event. This will be accomplished through the establishment of a real estate bureau within the county. The power of foreclosure, or better the necessity of invoking the power of foreclosure, should be optional with the county foreclosure officials. This discretionary power should allow for proven cases of misfortune, death, sickness, and unemployment or other valid reasons for non-payment. The foreclosure procedure should never be used when there is the slightest chance that the parties will pay up. The opportunity to accept or reject the partial payment plan would be a test as to the intent or earnest desire to meet the back taxes and on refusal to meet the payment, foreclosure should be instituted.

The statutes governing forfeited lands should be amended to provide that foreclosed property not sold within two years' time be forfeited to the county. This will take it off the tax duplicate until such time as it can be sold to capable taxpayers. Forfeited property should be subject to sale at any time for any amount that will approach the fair market value of the property. Sale should be made to individuals who can demonstrate their ability to improve the property and become permanent taxpayers. This will be accomplished by the county real estate bureau.

The present receivership act should be reenacted to reach all properties having a yearly income of $1,000 or more. This change should not be made so as to necessitate the appointment of a large staff of additional officials to handle the properties but provision can be made by the establishment of a receivership department within the county treasurer's office and eliminate the necessity of a large set of individual receivers. The approval of the revenue col-

lecting officials should be required on all expenditures made on properties in receivership, keeping in mind the necessity of not allowing the property to depreciate in value, but beyond that to collect the delinquent taxes.

In order to minimize delinquency in the future the commission proposes that:

A. The state tax commission should evolve a standard system of record-keeping for all counties.
   1. This record should include complete data over the entire delinquent period.
   2. Provision should be made for accounting for partial payments.
   3. The record should be in such form as to facilitate determination of the total delinquency for any particular taxing period.
   4. Installation of new equipment where necessary to handle the new records.

B. Legalize the acceptance of monthly payments in all counties and institute monthly billings.
   1. Many delinquents will be able to meet monthly obligations whereas they never are able to get enough together to meet a semi-annual or annual payment.
   2. Sound business procedure endorses monthly billings, so why shouldn't the government adopt the same policy?

C. The sole security for bonds, principal, and interest of which are to be paid from the proceeds from special assessments, should be the property against which those special assessments are levied—not the full faith and credit of the community.
   1. Perhaps this idea should be carried further, to the extent of saying that cities should not accept a subdivision until promotors have paid for improvements. It then becomes the promoters' problem to get the alloted share of the cost of water mains, sidewalks, streets, etc. out of the price of the lot. Such a policy will tend to control speculative development which had created a greater part of the delinquency in the urban districts.
   2. Further consideration to build into such changes as should be made to cover the general topic of special assessments. The safest policy for any taxing subdivision to follow is that based on a "pay as you go" program. Why continue the practice of issuing bonds to finance an ordinary project and then paying up to and over 100 per cent interest charges before the bonds are finally redeemed? It is a

common saying that we have a perpetual debt, but need this be so if we institute sound financial planning in the local taxing unit?

D. The methods of appraisal of property should be revised.
   1. A plan should be devised whereby the county directors of finance are required to select adequately trained and thoroughly competent appraisers. Perhaps the state bureau of local finances, as hereinbefore suggested, might set up minimum requirements of competency for all appraisers.
   2. All property should be placed on the tax duplicate at 100 per cent of its current market value. The inclusion of all property on the duplicate coupled with the practice of re-appraisal at intervals of not less than two years.

E. A general plan for the control of land use should be instituted to prevent another of over-expansion of urban communities such as was the case in the late twenties.
   1. Require each municipality to set up a planning board which will confer with the state bureau of local finances on questions relating to taxation.
   2. An effort should be made to return much of the present idle land to productive use where that land can be profitably tilled. As long as it remains in undeveloped allotments it will continue to be delinquent. The desired general policy is that administrative procedures be worked out in conjunction with the present conservation program.
   3. It is recommended that an investigation be conducted to determine what can be done to discourage the creation of additional municipal corporations in metropolitan areas.

Recording Secretary: Leo Day Woodworth, chief of research staff, Michigan Tax Study Commission, commented on the difficulties involved in determining the basic causes of tax delinquency. Failure of past investigations to provide answers as to causes is due in part to the fact that information on individual cases is not available from official records. Complete analysis is dependent upon assembling data pertaining to extent, location, cost, and the relationship between general taxes and special assessments.

P. A. Herbert, professor of forestry, Michigan State College, pointed out the difference between "long" and "short term" delinquency. "Long term" delinquency is generally associated with resort developments that have gone sour, subdivision schemes that have gone awry, and forest regions after cutting operations have been completed. The problem associated with "long term" delinquency is one of how to prevent. A program with this end in view

must make provision for limiting the platting of lots, and otherwise control land uses. Professor Herbert pointed out that there are no procedural problems in "long term" delinquency.

"The tax collection problem can be divided into two parts, (1) collection of taxes from those owners who intend to pay their taxes and (2) collection of taxes levied against properties where the owner has little or no intention of paying them.

"Where the owner has the expectation of paying the tax we find the properties usually characterized as improved or income-producing properties upon which the tax load is very definitely only a small fraction of the market value of the property. Here the collection problem is one of reaching the owner, impressing upon him the time taxes are due, and the saving to him if he will pay on time. During depressions collections will be larger if taxes can be paid in installments. In cities and other tax collection units the personal touch between owner and tax collector can not be maintained but can be replaced by owner confidence in an orderly and efficient tax collection procedure. In rural communities tax collections will be made more readily if the personal relation between owner and collector can be maintained.

"In reference to the collection of taxes from owners who have no intention of paying the tax levy, it is a matter first, of providing a procedure that definitely makes every opportunity available to the delinquent owner to pay his taxes and then proceeds *rapidly* to liquidate the delinquent property before the tax burden becomes so great that no one can assume it. Vacant suburban lots and other areas with heavy special assessments often fall into that class. Finally, there are non-agricultural cut-over lands whose income-producing value is so low that private ownership is weak and not socially desirable. For such land the procedure should permit its eventual reversion to a strong public agency (federal, state or county) to administer for public purposes. Such land should not be repeatedly offered in a bargain sale to private owners. History has clearly shown that this procedure is expensive, socially undesirable and does not lead to continued private ownership."

H. K. Allen, professor of economics, University of Illinois, took issue with Professor Herbert's position that "long term" delinquency is not a problem of tax collection procedure. His remarks in this connection were as follows:

"I am not sure that I disagree with Professor Herbert, but I should like to make a few remarks regarding his statement that long-term delinquency is not a problem of tax collection procedure. I agree that rural zoning and similar restrictive methods are appropriate devices for dealing with long-term delinquency. It seems to me, however, that long-term delinquency is very definitely a part of tax collection procedure. The distinction between short-term and

long-term delinquency is simply one of degree. Every effort should be made, of course, to collect taxes when they are due or as soon thereafter as possible. We now have a large volume of chronically tax-delinquent lands, and, regardless of the measures adopted to deal with short-term delinquency, we are faced with the problem of administering this property. A point is reached eventually when the property rights of the individual, as respects delinquent property, must yield to the interests of government. I do not know where that point is. It may be two, three, four, or more years after delinquency. It would probably not be the same everywhere. After the individual has been given every reasonable opportunity to redeem his property, the government should institute a vigorous proceeding to foreclose the tax lien. This proceeding should clear the title of all liens and encumbrances. The property should then be offered for sale to private individuals if it is found suitable for that purpose, and if not, it should be converted to an appropriate public use. This final step which involves chronically-delinquent property is, it seems to me, an important step in tax collection procedure, although the function may not be administered by the tax-collecting department."

Richard W. Nelson, senior taxation economist, U. S. Forestry Service, pointed out that the position taken by Professor Herbert with respect to the desirability of personal as opposed to impersonal relationships in the field of property tax collection is at variance with current trends and contrary to avowedly good administrative procedure. The property tax is an *in rem* levy and should be administered accordingly. Mr. Nelson suggested that less of personal considerations rather than more, promised most in the way of improved collection procedure. Marital status, number of dependents, and size of income are appropriate items to consider in connection with personal taxes, but they have absolutely no place in the field of property tax administration.

Mr. Chatters expressed a sympathetic attitude toward Mr. Herbert's notion, by saying that those cities performing the best job in property tax administration were doing so on a personal basis.

George O. Fairweather, chairman, Citizens' Committee on Tax Collections, outlined the effort being made to analyze the nature of the delinquency existing in Chicago. The committee was organized following a meeting held in February, 1938 at the Union League Club. At that time such information as was available indicated that approximately 20 per cent of the current tax bill of any taxpayer represented a burden resulting from the non-payment of taxes on the properties of others.

The objective of the committee was to discover through a sampling process the characteristics associated with delinquent properties. On the assumption that delinquents were identified largely

with higher-valued properties, the initial study centered around properties with a tax bill of $1,000 or more in 1936. From two to ten blocks in each of thirteen typical use areas were selected for the sample study.

Analyses thus far made have led to rather definite conclusions as to the causes of collection failure. They are: (1) the growing tendency on the part of the courts to usurp the prerogatives of assessing officials; and (2) division of administrative responsibility. The committee concludes that the delinquency problem is nine-tenths one of administrative deficiencies.

It is hoped that responsibility can be developed in the departments charged with revenue administration, records keeping improved, and that tax title buying can be made attractive. Accomplishment of this last objective involves making provision for right to possession, and a good title.

Mention was also made of the necessity for permitting the county to bid in order that equity owners may not acquire the properties at too low a figure.

In response to a question asked by Mr. Witherspoon of Detroit regarding operation of the Illinois receivership law, Mr. Fairweather replied that in its early days it was an effective device in Cook County. Its indirect effects are now more potent than its actual operation. The fear of having a receiver named has materially improved collections for those properties in the income-producing category.

From the nature of several remarks made from the floor it was apparent that the tax sale procedure prevailing in Illinois was not clearly understood. This was particularly evident when Mr. Cobo of Detroit suggested the application of procedures which had operated with considerable success in Detroit.

Douglas Sutherland, executive secretary of the Civic Federation and Bureau of Public Efficiency, explained the essentials of the Illinois sale procedure. His statement was as follows:

"From Mr. Cobo's remarks I gather that our tax sales procedure in Illinois is very different from what it is in Detroit. In Cook County, at least, the sale of property for delinquent taxes constitutes nothing more than a lien upon the title of the property and does not carry possession. The tax buyer pays the full amount of the tax, costs and interest penalties, and the certificate of purchase which he receives constitutes merely a lien upon the property. The owner may redeem by paying to the county clerk the amount paid by the buyer plus the bid penalty (not exceeding 12 per cent of the amount of the tax) if paid within six months after the date of sale, twice the bid penalty if paid within twelve months, three times the bid penalty if paid within eighteen months, and four times the bid penalty if paid within two years, and plus subsequent taxes

paid by the buyer with interest at the rate of 7 per cent per annum. At the expiration of the two-year period the tax buyer may proceed to secure a tax deed to the property, but the technical difficulties are such that even a tax deed rarely amounts to more than a lien and a cloud upon the title."

G. A. Looman, county treasurer, Cass County, Illinois, pointed out that the shortcomings of Illinois tax laws were not as important as the laxity of enforcing existing statutes. As a case in point Mr. Looman gives below a brief review of what is being done in his county under the present laws.

"In addition to our regular tax sale, and a law providing for the county treasurer to have himself appointed receiver of delinquent real estate (which is our most effective law), we have also a law on the statute books of Illinois which provides that in cases where the county judge, the county clerk and county treasurer certify that the taxes and special assessments on forfeited lands or lots equal or exceed the actual value of such property, the officer directed by law to expose for sale delinquent lands shall offer for sale to the highest bidder such lands or lots. In Cass County this is the duty of the county treasurer, who is also ex-officio collector of taxes. He must, of course, give the customary notice of time and place of sale. The purchaser receives a tax certificate, same as at our regular tax sale, and after two years a deed, provided he has paid the taxes for the intervening years. The original owner has a two-year period of redemption, but must pay the entire amount of taxes due at time of sale, not the sale price, otherwise the law could be used to unload taxes. The amount received at such sale is pro-rated to the various taxing units and the remaining taxes wiped off the books. Since the property represented a 100% loss on the tax books, the above way is most practical. We have sold quite a number of properties in that manner. Some of the buyers have received their deeds and improved and remodeled the properties, and up to the present time the validity of this procedure has not been questioned. We never sell a property in this manner, however, if it is in rentable condition. In that case receivership will bring better results. Neither do we offer a property at auction unless we have the assurance of a fair bid before the sale. We also advertise these sales well, as it is good publicity and has a wholesome effect on the public who haven't been taking their tax paying seriously.

"The main object, of course, is to get the property into an owner's hands who will pay the taxes in the future.

"Four years ago Cass County was doing business on borrowed money, but by using the various means of collecting, and especially by making taxpayers realize that taxes must be paid, we shall close our books this year with a sixty-thousand-dollar balance."

(Adjournment)

SEVENTH SESSION

DINNER SESSION

TUESDAY, OCTOBER 25, 1938, 6:30 P. M.

CHAIRMAN LELAND: May I have your attention, please?

I would like to ask Mr. Frank Cody, president of Wayne University, and superintendent of schools of Detroit, to stand up. Mr. Cody has been kind enough to make available for this evening the All-City High School Banquet Orchestra, under the direction of Mr. Arthur H. J. Searle, supervisor of music in the Detroit public schools.

As a tribute to the orchestra and Mr. Searle, may I ask the audience to give the boys and girls a great big hand.

At twelve-thirty tomorrow the first buses will leave the Statler Hotel for Greenfield Village. It is hoped that all the ladies here will get lunch before that time and arrange to go to Greenfield Village on the twelve-thirty bus. There will be another bus for the men leaving at two-fifteen, and you will see one of the sights of the country, the museum of America, which Mr. Ford has constructed at Greenfield Village. It is quite a thing to see in Detroit and I am sure you will all be well repaid. Further details about that are in your entertainment program.

The next thing I want to call to your attention is the fact that the evening session will be at the Dearborn Inn. That is an inn run by Mr. Henry Ford modeled after the old New England inns, and run by the Treadway management, which has made famous many a New England meal. The Dearborn Inn is probably the most celebrated place in and around Detroit for the food that is served and one of the finest places that you can go in many miles from Detroit. We hope that you will buy your ticket for that dinner early in the morning as we have promised to let the Inn know by eleven o'clock how many things to start cooking. You will find also that it is well worth your while to go there. I can recommend the inns under the Treadway management very highly. I spent a summer eating about as many meals as I could at their inns. If you have any other doubts about the kind of things to expect, you had better get the New Englanders present in a conference and get them to confide to you what they think about some of the eating places and some of the quaint things that are available in those inns. That is the only sales talk I am making tonight, and the last thing that I will do.

I want to present our toastmaster of the evening, Mr. Alfred H. Stone, and whatever is done after this Mr. Stone will do. I didn't want to start this thing off with all these announcements and interfere with any of the other portions of the entertainment and the program. However, there is one other announcement I must make. After this dinner this evening, in the Bagley Room of the hotel, the "Government of Detroit" movie is going to be shown. That was prepared under the direction of Mr. Kenneth J. McCarren, a member of the board of assessors here in Detroit, at a time when tax collections in Detroit were few, and when the city was doing everything it could to stimulate the collection of taxes. It is an experiment in public relations, particularly of a government with its taxpayers, and is well worth seeing. It ought to give some of you some ideas about popularizing your city, state and local governments, and I can highly recommend that you see that particular movie.

I have looked at all of these slips and I haven't any more now to recall, and Mr. Stone will take charge when there is anything more to do.

TOASTMASTER STONE: There won't be anything more to do until after we finish the meal.

(The dinner was continued.)

TOASTMASTER STONE: Ladies and Gentlemen: When Professor Leland asked me to preside at this evening's session, I was particularly glad to comply with the request because this occasion is going to be devoted to a discussion of taxes and tax problems from the taxpayers' point of view. I think we owe it to ourselves to emphasize a little bit more the fact that the National Tax Association conference is not an aggregation of tax-gatherers. In the main, the gentlemen who compose this association are devoting their lives to a discussion of tax problems and they are just as much concerned with the amelioration of tax burdens, whether by shifting the incidence or some other means I won't undertake to say, but they are just as much concerned with that phase of the tax problem as the taxpayer himself. I am not orthodox on the matter of taxes. I think those of us who are interested in taxes owe it to ourselves to stress the fact that taxes simply represent the difference fundamentally between savage and civilized man. The disorganized or unorganized man in the savage state didn't have any need for taxes. As we become more organized and more civilized and more progressive, whatever that may mean—I am dubious about the proposition of progress and what it constitutes—why we want more things and we have to raise the money to pay for them.

It is a very pleasant thing to take part in these gatherings, and it is really a very great pleasure that Mr. Leland has given me in

asking me to serve in the capacity of toastmaster to introduce the gentlemen who are going to speak to us this evening. I have been at some pains to inquire about them. I like to know the men I am going to introduce, not that there is anything risky or unsafe about it, but I just like to know something about the people that I am going to be associated with. I have never in my life received more satisfactory assurances as to the character and good quality and general worth of any bunch of speakers in my life than I have these who are going to talk to you right now.

I have also had some opportunity of discussing some of these things with these gentlemen, and I am particularly gratified to introduce the gentleman on my right, Mr. Jackson. He is known to a great many of the older citizens of Detroit. He was identified here for a great many years as general counsel of the Westinghouse Electrical Manufacturing Company. He is now a resident of Pittsburgh. He is interested in everything which goes to add to the sum total of human happiness. In addition to being a scholar, he is a charming gentleman, and it is with a great deal of pleasure that I present to you Mr. John J. Jackson.

MAJOR TAX PROBLEMS OF INDUSTRY

JOHN J. JACKSON
Attorney-at-Law, Pittsburgh

I naturally feel much embarrassed tonight in appearing before what I consider the most critical and important association in the country.

When I come before an audience like this I am always reminded of the horse thief who, in the Wild West days, was caught red-handed by the Vigilantes. Their practice was to hang a thief to the nearest tree. The sheriff had this fellow up on a temporary scaffold with the rope thrown over a limb and the dark hood drawn over his head ready to push him off into eternity. A little wizen-faced fellow standing down in the crowd piped up and said, "Sheriff, I think we ought to point a moral from this affair, and if you have no objection I would like to say a few words." The sheriff turned to the prisoner and said, "Have you any objection to his making a speech?" The fellow answered, "No, but hang me first."

I have no new ideas and I suggest no reform. I hope I shall not be in the position of the politician who was wrangling away with a political speech and, in a loud voice, said, "What we need is liquor reform. What we need is tariff reform. What we need is tax reform." An old farmer sitting in the back of the audience said, "What you need is chloroform."

This association, of course, deals with taxes. This word "tax" comes from the Latin word "tangere" which means "to touch."

That is certainly an appropriate and symbolic name. We have all been "touched" and "double touched" since the World War.

The subject of taxes is as old as civilization itself. Back in Bible times the Levites gave tithes of one-tenth, and from our present viewpoint in these days I would say that the Levites got off easy. Anyway, the Levites have always been fairly succesful in bringing in the tithes.

There was also mentioned in Bible times Caesar Augustus. Caesar Augustus was born about 1 B. C. and afterwards concerning him it was written, "And it came to pass in these days that there went out a decree of Caesar Augustus that all the world should be taxed." At the time that seemed a trifle ambitious in Caesar Augustus but we certainly realize today that he made good and this plague of taxes has been passed down to us and will be always with us. It is not only with us while we live but follows us after death in the form of estate taxes. I am led to believe that there will be taxes in Heaven, and I know they are in the other place, because the common name of that place is only another name for taxes.

After this decree of Caesar Augustus, people flocked from the different provinces to the cities to pay their tribute or taxes. It may be interesting to this audience to note that one of these taxpayers who came up from Galilee to pay his taxes in Bethlehem was a man named Joseph who brought with him his wife, Mary. He came late and found that all the rooms in the inns of the city were taken and so he had to find lodging in the manger of a stable. In that manger, in the course of their stay, a son was born to Mary, and later in his life, but still in the reign of the Caesars, this son was one of the first to give his views on taxation existing at that time, and I might congratulate you tonight that He was, so to speak, one of the forebears of the National Tax Association. When the Pharisees got together and took counsel how they might entangle Him in his talk, they said to Him, "What thinkest Thou? Is it lawful to give tribute unto Caesar or not?" And His answer was, "Show Me the tribute money." And they brought unto Him a penny, and he said, "Whose image and superscription?" And they said unto Him, "Caesar's." And He said to them, "Render unto Caesar the things that are Caesar's." So I would paraphrase that statement tonight and say, "Render unto government the things that are government's," which, being interpreted, means if you have a government you must support it.

* * * * *

Ordinarily I dislike statistics, but a "Far Eastern Affairs" pamphlet came across my desk the other day and immediately challenged my attention. Listen to this:

> "The United States contains 6 per cent of the world's area and 7 per cent of its population. It normally consumes 48 per cent of the world's coffee, 53 per cent of its tin, 56 per cent of its rubber, 21 per cent of its sugar, 72 per cent of its silk, 36 per cent of its coal, 42 per cent of its pig iron, 47 per cent of its copper, and 69 per cent of its crude petroleum.
>
> The United States operates 60 per cent of the world's telephone and telegraph facilities, owns 80 per cent of the motor cars in use, operates 33 per cent of the railroads. It produces 70 per cent of the oil, 60 per cent of the wheat and cotton, 50 per cent of the copper and pig iron, and 40 per cent of the lead and coal output of the globe.
>
> The United States possesses almost $11,000,000,000 in gold, or nearly half of the world's monetary metal. It has two-thirds of civilization's banking resources. The purchasing power of the population is greater than that of the 500,000,000 people in Europe or the more than a billion people in Asia.
>
> Most of us believe that a governmental and economic system under which the foregoing has come about or is permitted, and under which the American people have attained the highest standard of living the world has ever known, is good enough to preserve. We agree that changes are required from time to time to keep pace with the advancement of science and invention, but we believe that these changes can all be made within the framework of the existing structure and without impairing that structure."

There are some few people who want to destroy this system under which we have grown so great that we are the envy of the world, but President Roosevelt stated our position when he said: "We don't want, and are not going to copy, other forms of government. Ours is good enough for us."

This is the basic belief of industry and, after all, like it or not, industry more than any one thing has provided the means or the opportunity of bringing about this more abundant life.

I believe there is one fundamental of our government that has gone far beyond what its framers anticipated. The government of our country, when established, was in the people—a pure democracy. At that time a mere handful of people set up our government as their servant, as something that could render them a service; the creators of this government, in turn, making proportionate contributions or taxes to cover the cost of such service. But in the course of this time this creature we established has expanded with such rapid strides and has grown so great that instead of taking the authority delegated to it by law, it now assumes authority to tell the people who created it what they should do. In other words, the creature has grown bigger than its creator.

It is, perhaps, about time that "We, the People" once more told this creature government how we would like the government conducted rather than having the government tell us how our lives should be conducted.

I feel quite out of place in discussing tax problems before this group, feeling that each of you knows more about taxes than I possibly can, and my only hope is that I may give you some actual and practical problems rather than theoretical out of my experience in industry.

We are all agreed that the basic thing about taxation is the contracting of the expenses. When once the government expenditure is made, the resultant tax must be met. The money must be raised, and perhaps it does not make so much difference as to the form of taxation provided the tax is equitably distributed. Our first duty as citizens, then, is to do our part in keeping government expenditures down to a point consistent with modern demands — in other words, to prevent extravagant expenditures.

Are Taxes Too High and, if so, What is their Effect?

An industrial taxpayer must derive its taxes from the manufacture and sale of its products. It cannot sell its products unless it makes a product just as good as its competitor and unless it can sell such product at the same or a better price than its competitor. Competition in the field of price limitations is a serious one. Tax requirements must constitute a part of the construction of that price. High and increasing taxes have done more to upset the equilibrium of our economic structure than any other single factor. In considering this problem we must realize that taxes on industry ultimately are paid by the consumer and accordingly we should not maintain a system which does not recognize this fact. If the consumer must pay the taxes in the final analysis, then he must have something with which to pay such taxes. He must have the opportunity to work and earn money with which to purchase goods. Industry is the great employer of labor. Capital is necessary both in old and new enterprises to provide such employment. Capital is entitled to a fair return, and in order to secure a fair return there must be an inducement presented for investment possibilities. Destroy the flow of capital and you destroy labor. Destroy the earning capacity of labor and you are eating into your taxing structure to such an extent that will bring about ultimate failure.

Let us examine into the question of some of the taxing statutes that have a tendency to produce a barrier in expanding this economic philosophy. You will pardon me if I use illustrations out of my experience with the Westinghouse Company, because I know then whereof I speak.

At the beginning of the depression the Westinghouse Company had a surplus of approximately $95,000,000. As the depression

progressed this surplus reached a low point of $35,000,000, of which approximately $16,000,000 represented paid-in capital. Every effort was made to maintain an organization capable of obtaining and handling the business available. Economies were effected in wage reductions, salary reductions, and other overhead expenditures represented by nearly every item in the trial balance. When it came to the item of taxes, however, management was impotent in accomplishing anything in the way of reductions. Taxes increased in many cases while other items of expense decreased. Just when the sun brightened with the prospect of increased business and increased revenues, the federal congress saw fit to enact the so-called "Undistributed Profits Tax." Had our company not had available its surplus of $95,000,000 it would never have weathered the storm of the depression. We know that depressions go and come and we know that surpluses of industrial organizations aided in alleviating the terrible hardships encountered as a result of the last depression. We know that we have not seen the last recession in business and we know the difficulties of overcoming each recurrent recession, and yet with all this knowledge there is enacted a piece of tax legislation that undoubtedly directly tends to stop the preparation for the future.

Perhaps the government feels that these depressions or recessions will in time show us how to get along without money. One of the best illustrations of this is the old Georgia cracker. He had an old worn-out farm, buildings tumbling down, and hardly enough for a crow to exist one. A traveling man came driving by one day about noon-time and, with true southern hospitality, the old cracker invited him to break bread. They sat down to the frugal repast at a plain board table, being joined by a third man. The traveling man said, "Partner, how is it you are able to get along? I can't understand for the life of me how you eke out an existence." "Well," said the cracker, "I will tell you. You see that man at the other end of the table? That's my hired man. He has worked for me two years and a half and I have not been able to pay him a cent. In another six months he will own the place. Then I will start working for him and in another three years I will get it back." No money changed hands in that transaction.

High Taxes Stop the Flow of Capital

It has been demonstrated, also, that the tremendous expenditures of government have resulted in a tying-up of capital that would nominally be used in business ventures.

Why is it not better to clip coupons than to struggle with exorbitant taxes and labor troubles?

When capital consumption is greater than capital creation and when this result is brought about by high taxes, then it is time to

give the tax problem some serious thought. This decrease in available capital is undoubtedly traceable directly to high taxes.

We know that "isms" are taking this country by leaps and bounds in the form of demands for unreasonable and impossible Utopian social legislation which must be paid for in some forms of taxation that undoubtedly aggravate the existing situation in its effect on industry. Can we not take the government out of these paternalistic schemes so that we can reduce taxes and create employment and start the existing cycle in reverse? Let the government remove some of its restrictive policies on business and see how much brighter will be the outlook and how quickly the existing emergencies will tend to disappear. Private industries can do these things quicker than government and that has been proved by past experience. We have the most today of any people on the face of the earth, largely due to the ingenuity of private industry. The great advances happened in a period when private industry could function with the least restraint and when taxes were lowest.

These statements regarding taxation apply to the states as well as the federal government. I say to you that taxation today determines the state where industry locates. May I give you a concrete illustration? One of our subsidiaries had a plant in a certain state. This state attempted to tax the sale of our product not only where manufactured, but in every other state in the Union. We closed down our plant and sold it at a sacrifice.

Massachusetts drove industry from her borders, but of late she has been wooing them back and is now doing a good job.

In dealing with taxes in the different states I used to say that Pennsylvania had the best taxing system. But no more.

Let me give you another example. We have a large manufacturing plant at Springfield, Massachusetts, where refrigerators are built. We also manufactured at that plant small motors. We wanted to divorce the small motor business from Massachusetts and bring it to the Pittsburgh section because of freight rates and for other reasons. We had idle facilities at Pittsburgh admirably adapted for this enterprise. Did we move it to Pittsburgh? No. We went to a neighboring state where we were welcomed with open arms, given certain tax privileges, and where we could compete without excessive taxation.

Administrative Difficulties

Aside from the tremendous dollar burden of taxes on industry for the past few years probably one of the most serious problems is that of complying with the various taxing laws. The Westinghouse Company, an ordinary manufacturing concern, maintains approximately 1,600 tax files of which more than 1,000 are what we consider active files. It is necessary to review the greater portion of

these active files at least once a month. In many cases the cost of preparing the data for determining a relatively small amount of taxes is much greater than the tax involved. In our case we have estimated that the administrative cost will probably exceed 2% of the amount of the tax involved, which is a staggering burden on top of the tax itself.

Do you have any idea as to the number of problems that are presented in analyzing sales to determine the jurisdiction within which such sales should be reported? If one had to analyze each invoice involving one hundred thousand dollars worth of sales the task would be laborious, but when one must analyze millions the burden becomes stupendous.

Can you visualize the effort required for complying with federal and state social security and unemployment taxes for an organization involving 50,000 individuals scattered throughout the entire United States? This alone requires the filing of several hundred thousand tax returns which involves substantial indirect expenses.

Merely mentioning real and personal property taxes as a practical illustration of the work involved, I have in mind a state wherein our company files a report of its tangible personal property for eighty-five of the eighty-seven counties of the state. The taxes imposed apply to two hundred and sixty separate taxing jurisdictions. A complete and careful record must be maintained for each separate taxing jurisdiction. The report is filed and carefully audited by the taxing authorities and a recapitulation made and a breakdown of same distributed to each county auditor who must render separate tax statements for each taxing jurisdiction involved. A different tax rate will apply to each separate taxing district. As the taxpayer we must issue separate vouchers for each county and redistribute and account for the expense for each company operating unit involved. I assume that no one with practical experience in dealing with these matters will deny that administrative problems present one of the greatest difficulties. I do not mention this case in the spirit of criticism but merely to bring out the difficulties encountered.

Taxing authorities should listen with a sympathetic ear to the pleas of taxpayers for added time within which to prepare and file the voluminous data they require. The principal amount of the burden represents an overload for the first six months of the year when most taxing jurisdictions require their reports to be made.

Social Reform Taxes

Many of our taxing statutes have been enacted to bring about a social reform. The "Undistributed Profits Tax" had this as one of its objectives as a result of a school of thought developed by theorists who have no practical experience in the application. Why, again I ask, do we not consult industry to determine whether these

measures are good for the country at large? Why, again I ask, is government so concerned in adopting the impractical suggestions of theorists as compared to the practical suggestions of those who must pay the staggering burden of taxation?

More discussion and a better understanding should be given to the cost of government, to efficiency and economy in government, to the establishment of business methods in operating our government, to a better education of the citizenry as to their responsibility to government and their understanding of government. Only in such great associations as this can progress be made along these lines. When this is done then we shall see an approach to a sane solution of not only the tax problems of industry but the tax problems of every class. In discussing forms of taxation we should confine ourselves not to the social aspects but to the aspect of raising revenue only as a tax problem and the equal and fair distribution of the burden. There must be a return to the principle that taxes will be imposed for revenue only and not to correct social evils.

The increase of employment should be the part of industry, not government, and government should in the matter of taxes put industry in a position to give more employment. No less a distinguished Democrat than Grover Cleveland expressed very forcibly these principles, as follows:

> "When more of the people's sustenance is exacted through taxation than is needed for the economical administration of the government, such taxation becomes ruthless extortion, and is a violation of the fundamental principles of a free government."
>
> "The lessons of paternalism ought to be unlearned, and the better lesson taught that, while the people patriotically support the government, the government's functions do not include the support of the people."

Cooperation between Industry and Government in Formulating Tax Laws

Any person who has been associated with a large corporation over a period of years and has seen the tremendous growth of the taxes such an organization must pay, realizes that the subject of taxation is one of the most important of the day. Yet literally thousands of tax laws have been enacted without consulting the taxpayer to determine whether those laws were good, bad, or indifferent. In fact, there is among politicians a tendency to rush tax bills through before the taxpayer has time to understand them. Industry is unfamiliar with the problems of government, including tax administration, just as government is unfamiliar with the problems of industry. It is about time for a "new deal" in handling this important problem of taxation. If industry has serious tax

problems, it is about time that we told the government about those problems and both sat around the conference table and decide the kind of tax to be imposed. No lesser person than President Roosevelt has stated that America has no tax system and that the time has come for definite action along practical lines. He has not suggested, however, to my knowledge, that business be brought into the picture of providing a tax system.

Bring industry and government together around the table before the bills are introduced. May I illustrate what I mean? When the political bodies feel that there is a need for certain tax legislation, why not call in the taxpayers against whom the bill is aimed and get their views. This, I am sure, would prevent many unwise laws being passed. People are not unreasonable and are generally willing to look at the opposite viewpoint. A certain law was passed in Pennsylvania which affected our company and other corporations. We felt that we must oppose this bill when it came up for hearing before the senate committee and did so, and the legislation was so plainly unwise that it was killed in committee. The proponent of the legislation after the hearing, who was very fair, came to me and said, "I had not the least idea when I introduced that bill that it would have the effect you stated, and had I known it I never would have introduced it."

Had the legislative committee called in industry representatives around the table when the bill was being discussed this thing would not have happened, with the attendant annoyance and expense to both taxpayer and state.

Business Confidence

Perhaps the most important thing right now is restoration of confidence. The government should never be at loggerheads with industry and business in bitter strife, and that is the way we have been drifting. I am glad to note that in the last two weeks in Washington there has seemed to be a change for the better in the relationship between government and industry. When we look at the European crisis, it is high time that we stressed internal unity in the United States.

With industrial taxpayers daily making statements regarding the hindrance of the tax burden and the destruction of confidence in the government's imposing that burden, it is time to take serious note of this condition. These are no idle statements but represent those of responsible citizens of our country that honestly believe that a reduction in the staggering tax burden resulting from the enormous government expenditures will open the way for new industries and expansion of existing industries to a point where it will relieve the unemployment problem. The unemployment problem is probably causing and bringing about the greatest portion of our immense tax burdens. Instead of the government trying to feed and clothe our

unemployed, let industry assume that burden in place of government, and let government give industry the chance and opportunity of earning sufficient so that men can be taken off relief and put back to work at a fair wage.

There are some strange things in this tax business. We talk about government putting people on relief. Government never put one soul on relief. It is industry and other taxpayers that put people on relief. Government is merely the collector of the money. Our industrial system that some say has failed, is what has carried the bulk of the burden of relief and all other expenses of government.

In making these comments I want it distinctly understood that I am not criticizing the government. I am not saying that the government is entirely to blame for the present state of affairs. It may well be that people must be fed and clothed no matter what the circumstances under which they have reached unemployment. Let me say, also, I have no patience with industry continually quarreling with government and vice versa. Cooperation and understanding is what is needed.

Lest I leave you in too gloomy a mood, let me give you this picture, from a tax magazine, as to why taxes are not so bad.

> ". . . there is always a chance with taxes—two chances in fact; you are either taxed or you are not taxed, and if you are not taxed you are all right, but if you are taxed you still have two chances, you are either taxed too much or too little; if you are taxed too little you are all right, but if you are taxed too much, why, then you still have two chances, because you can either get your tax reduced or you don't get it reduced. If you get it reduced you are all right, but if you do not get it reduced you still have two chances, because you can either pay it or not pay it; if you pay it, it is all right; but if you don't pay it you still have two chances, because you then can be sold out or not sold out. If you are not sold out, it is all right, and if you are sold out you have two chances, because you can either redeem your property or not redeem it. Of course, if you redeem your property you are all right, but if you do not redeem it you are just as well off as you were before, because then, you see, your have lost your property and you haven't any taxes to pay, and you come back to the first position where you are not taxed at all. So you see, that in the end taxes are not so bad."

I have tried to give you the major problems of industry from the taxpayer's standpoint as I see them in connection with taxation. One thing seems certain—changing the forms of taxation is not the approach to a solution of the difficulties. I admit, too, that I do

not know the solution to all these problems, but associations such as yours can reach a proper solution.

May I say in conclusion what I personally feel is back of the situation in which our country finds itself today?

I think we have paid too much attention to material things. Our forefathers who drafted our constitution were a religious people. While I am not a particularly religious individual, I am inclined to think an old-fashioned religious revival would help this country and the world.

Up to the time of the depression, we were money mad. The thought uppermost in the mind of every man who was making money and more money. Those called the great leaders of our country gave the impression that there was nothing that money could not buy; but, gentlemen, they forgot art, and literature, science, music and poetry. There are many things — in fact, the greater things in life—that money cannot buy. You have all heard of Benvenuto Cellini, master craftsman of all ages. He strolled about Italy building for kings, popes, and others who employed him, the most beautiful works in silver and in gold. Wherever he stopped was his work-shop. Sometimes he had an assistant and sometimes he had none but the things he created are priceless. There is one of these treasures in this country. You will find it in the Altman collection of the Metropolitan Museum in New York. It represents a turtle bearing on its back a most beautiful and wonderful vase. The only light that strikes upon it in its glass case comes from the ceiling above, but as you stand and gaze upon it, it is like a burst of the rising sun.

You can buy that cup with money, yes, but you cannot buy the artistry that fashioned that cup with all the wealth of the United States, and that's what I mean when I say that many of the greatest and worthwhile things of life cannot be bought with money. The present European crisis teaches us there are many things more precious than money—our form of government and our liberty come above all else. And if this condition in which we find ourselves today has taught us only one lesson—to put our minds and souls more upon the greater things of life—then our tax problems will be largely solved and many of our economic ills will disappear.

Of late there have been some disturbing thoughts in connection with increased armaments in the United States. Where does the government first look in such an emergency? It looks to industry! In the recent debacle of Czechoslovakia, the one hero who stood out was not, to my mind, the ambassadors of those countries whose names reached the headlines of the newspapers; but the unnamed hero of that conflict to me was Jan Syrovy, one-eyed inspector general of the Czech army. Perhaps you never heard of him. Then I bring you a new hero. A leader of the Czech army of World War fame, Syrovy fought with the Russian troops against the

Germans in the World War. He wears a black patch over the socket of one eye which he lost in Siberia, and there he stood while his country was being divided up, at the head of his little invincible army, ready, at a word from his government, to fight against Germany again or against the whole world, if need be, without the aid of France, or England or Russia, and to fight to the last man for the liberty of his little country, but never to surrender. That, my friends, is courage.

I say to you tonight that I know what the leaders of industry are thinking. I know they will have better relations with labor as the years go by and I know they will make more provision for security for old age in the near future. I know that they, too, have courage, and that in any emergency the majority of them stand, like old Syrovy, ready to do their part and to make the sacrifices necessary for the defense of our government. So I have faith that our country will come again into this new concept, that the old virtues that have brought us thus far will again reappear, and with new ideas born of our present experience, we will again go forward so that this nation of ours, with its boundless wealth, with its natural resources and with the skill and inventive genius of its people, shall always stand a majority against the world, in war, or in peace.

TOASTMASTER STONE: I know that you will agree with me that Mr. Jackson has given us a most helpful and inspiring address. He has fully measured up to our expectations, and to my promise as to what he would do.

I hate to say anything that will take us from the mental plane on which he has left us, but in presenting the next speaker I want to come back to some intensely practical things connected with the problems of taxation. I said a while ago that the difference between the taxation represented the difference between savage and civilized man. There are some things connected with the problem of taxation which are so simple, so matter of fact, that we lose sight of them. After all is said and done, all you can do in the way of solving problems and reaching conclusions, is to realize that taxes, in the last analysis, simply represent the constantly increasing demand of people for an expansion of governmental services. That demand may be stimulated, it may be artificially created. I know that is true. It may come as a result of propaganda. Undoubtedly that happens. At the same time, there is a tremendous portion of the total increase in the tax burden, which comes from the legitimate demand—according to the modern school of thought, at any rate—on the part of people for more than they had in the previous generation or the preceding decade.

I am going to trespass on the time of the next speaker just to say this: It is a homely illustration. It just comes into my mind. Forty-seven years ago I began in the Mississippi delta, the swamp

country it was called, to develop a cotton plantation. The taxes on that property were $250 a year. I improved it, operated it; I saw the taxes on it grow to $1,250, from $250. Every increase in the tax burden, year after year, with which I was definitely associated in a responsible way, represented some increase, some expansion, in the services which were being rendered by the state or by the county.

At the time I began, I was asked one day by a member of the board of supervisors of the county—the counties in that state are divided into five districts; each district represents a member of this board, and this county board has charge of business affairs with the county—to come into the county-seat, into the courthouse, and to attend the monthly meeting of the board. He said there was going to be something very important coming up, and he wanted some taxpayers, from the swamp country, with which I was identified, to be present. He said he had asked a number of taxpayers to be present, but he was quite sure none of them would come. I was young and I went. I dare say if I had been a little bit older I wouldn't have gone. I was the only taxpayer there. I sat around for quite a while, I told my old friend that I couldn't stay there indefinitely. "Well," he said, "you wait. I am going to bring this thing up and I just don't want you to leave now that you are here."

Finally he got up, and it was a proposition for the board of supervisors to authorize the sheriff to install a telephone in the county courthouse. That didn't come out of a joke book, it isn't a fairy tale, that happened. One of the older members of the board got up and made a very, very impassioned speech on the rising burden of taxes. He furthermore said, "Just after the Civil War, back at the close of the reconstruction period, we elected Will Hunt sheriff of this county, and he was sheriff for sixteen years. No matter how bad they were and how big they were he went out and arrested them, and he didn't need any telephone to do it with." He said, "As far as I am concerned, I don't propose to vote a telephone to the present sheriff," and they didn't give it to him.

All right. The difference between that situation and one which I was invited to see, or witness, a good many years after that, was the difference between no taxes or low taxes and very high ones. After I went to Jackson and took charge of the state tax commission, I had to go back to this same county-seat where this thing had occurred forty years before. We didn't have the same old courthouse, though, we had built two in the meantime. Each one of them, of course, represented a heavier bond issue than the other one, and the final courthouse had all the appurtenances of civilized society. It had wainscoated walls, and it had frescoed arrangements, it had tiled floors, and it had everything. The young sheriff took me into his office. With a great deal of pride he pointed out

the appointments of this sheriff's office. He wasn't born at the time I speak of in the first instance. He had come on the scene since that time.

He had a mahogany-topped table in his office about as long as this table here (indicating). It seemed to me that about every 36 inches was one of these patent French telephones. That was the first thing I saw. I said, "Ben, what have you got all these telephones for?"

"Why," he said, "Mr. Stone, this is a day of service. When one of these phones rings we can't keep a man waiting until he can walk ten or twelve feet over here and get to the telephone. He reaches out and grabs one and it gives him service right now."

"Why," he said, "we have six phones like this in the county jail."

What are you going to do about it? At the time I speak of you didn't have paved sidewalks in the county-seat, you had no sewerage system, no electric lights, no waterworks — you didn't have any of these things. To come right down to it, whether these demands are legitimate, whether the response is one that is absolutely necessary, whether these demands are stimulated, as I said a while ago, and whether the field of governmental service had been over-extended, as I personally believe it has, the result is just the same. Somebody is going to foot the bill. There isn't any Santa Claus in the tax game. I don't care who, somebody has to pay for it.

My friend, Mr. Williams, on my left is going to tell you who is going to pay for it. He knows, because he is president of the S. S. Kresge Company, with headquarters right here in Detroit. He can tell you all about it because he does business all over the country.

I take pleasure in presenting Mr. Williams.

TAXATION AND RETAILING

R. R. WILLIAMS

President, S. S. Kresge Company

The invitation of your program committee to address this conference of the National Tax Association is deeply appreciated. Only a few years ago, it might have been considered sheer presumption for a business man to attempt to participate in a conference such as this of experts on the subject of taxation. But we, who are engaged in business, have had so many encounters in recent years with taxes and taxing systems that we feel we have had the equivalent of a thorough course of instruction, and some of it at a very high rate of tuition. We, therefore, welcome this opportunity to discuss some of our problems with you.

In this brief statement, it will be the purpose to review some of the facts concerning taxation as they affect retailing and retailers. Most of these facts are accessible to all and may already be known to all. Such observations as may be made concerning these facts are to be considered as purely personal. I have no authority to

appear before you to speak for retailing as a whole, but am of the opinion that some of the views I shall express are held by many others, not only in retailing, but in other businesses as well. Retailers, like all other industrialists, are having a tussle to meet and comply with tax demands. It requires unusual restraint to accept all that has been done and more that is proposed, and to voice no protest.

Taxes, in any form, have never been painless. For these recent years and the present, science has yet to discover an anesthetic strong enough to deaden the process of extraction, and yet preserve the patient's life and reasonably assure recovery.

Whatever we may individually feel concerning taxation and its burdens and costs, we recognize that the costs of government must be met. Well, here is something about these costs, interesting and appalling. Your own statisticians have produced the information that the federal government, the 48 state governments and the 175,000 local government units in this country are now spending at the rate of nearly 18 billions of dollars a year. This is equivalent to $140 for every man, woman and child in the country. Or, since the family is more typically the income and spending unit, the government expenditures now amount to more than $560 per family per year. This, I think we will all agree, is a very considerable amount.

We are, moreover, told that our governments, federal, state and local, are at the present time collecting 12½ billions of dollars a year, amounting to slightly less than $100 per capita, or $400 per family. Enormous as this amount is, a deficit is being incurred amounting to approximately 5 billions of dollars a year. Our public indebtedness as a nation is increasing at the rate of about $160 per family per year.

No person with any sense of responsibility can escape a feeling of concern over this situation. The enormity of the problem becomes even clearer when we are faced by the further fact that the amount of taxes collected during the past fiscal year, a year still in the depression, is greater than collected in any preceding year in our entire history.

There can be but one conclusion concerning this condition, in which I am sure that all forward-looking business men join with you and others interested in the preservation of this country, and that is in the desire to see our public budget balanced as soon as possible and beginnings made in the repayment of our mounting public debts.

It is imperative not only from an economic but also from a political standpoint that steps be taken immediately to balance our public budgets, to reduce these budgets to the essentials that can readily be paid for, that taxes be raised to meet all government expenses, and our affairs put on a pay-as-you-go basis. No criticisms are

intended against any political party or against any past practices in politics or administration in urging vigorously that, from henceforth, our federal, state and local governments should get back to a basis of sound financial operation which everyone knows, or should know, is necessary. A budget left unbalanced for any considerable length of time, whether for a household, a business or a government, is not only unsound but extremely dangerous. At the present stage of our history and economic development, an unbalanced budget in any of our principal governmental units is inexcusable.

Retailers, in common with other business men, frequently complain about the amount of taxes they are called upon to pay. That is but human, and indeed the amounts, as we have already seen, are extraordinarily heavy. Serious as these complaints are, they are not nearly so serious as their complaints as to the kinds and numbers of taxes; to their intricacy and complexity; to their conflict with each other; to the numbers of tax reports that must be prepared and filed; to the costs of preparing such reports and to the endless conferences, discussions and litigation arising because of honest differences of interpretation of the present tax laws.

The company with which I am connected operates stores in several states, and its problems of preparing tax reports is compounded and multiplied. In 1937, we had to prepare, compute and pay 1,240 different taxes. In order to meet our tax obligations properly and fairly, we have to maintain a large office staff whose principal duties are the compilation of tax reports and the computation of taxes. We employ experts in taxation to keep us informed concerning the ever-increasing stream of tax laws and to help us to interpret their meaning.

A considerable proportion of the time and energy of chief executives is devoted to tax matters, time and energy taken from their attention to the productive management of business, time and energy which must be given in order to meet the requirements of the tax authorities. It is worth the notation of all students of this subject that our system of taxation has reached the point where it not only takes a substantial part of the *income* of American business, but also a substantial part of the time, energy and attention of business executives from their proper function of managing their businesses. Therefore, the cost of our present system of taxation is not to be measured merely in terms of dollars paid to our taxing authorities, but also in terms of the high expenses of interpretation, of compiling and computing tax reports, and in litigation over obscure and disputed issues. Considering both these direct and indirect tax drains upon American business, it is remarkable that it can do so well in providing employment and in distributing goods as it does.

May I remind you that retailers are tax collectors as well as tax payers. A few states and municipalities have sales taxes and the collection of these is put squarely upon merchants.

When first instituted, these taxes were most unpopular and retailers took the brunt of scathing criticism and protest.

And yet, merchants generally do not oppose this type of taxation until it becomes a further burden and drain upon them. That occurs when the collection from customers falls short of the amount due the state or city.

Just to mention two examples. In Michigan, with its tax of 3%, no tax is collected on sales below 17 cents. It is a tremendous expense on purveyors of low-priced merchandise. The same is true in Illinois.

When a concern has to make up several hundred thousand dollars, by which the collections are short of tax requirements on its total sales, such a tax plan ceases to be a sales tax only, and becomes a tax on the occupation of retailing.

There are no authoritative facts available concerning the total amount of direct taxes now paid by the retailers of this country. A conservative estimate for the variety trade, in which our type of business falls, is that all taxes, including real estate, personal property, franchise and other business taxes, income taxes on corporation earnings and so on, exceed 5% of total net sales. In other words, out of every dollar received, more than 5 cents must be paid to tax collectors. If tax conditions are similar in other retail trades to those prevailing in the variety trade, and I do not know of any reason why they should be different, then we may conclude that direct taxes paid by retailers now equal, if they do not exceed, all net earnings and dividends distributed to stockholders and owners. Indeed, taxes go on even though there be no net profits. The retail tax bill exceeds the amount paid for rent; it is greater than the amount paid for advertising, and is nearly one-half of the wages and salaries paid to retail sales people.

The problem of taxation affects retailing not merely as a direct charge on the business, but also, and even more importantly, as a charge upon the pocketbook of the American consumer whose purchasing power is reduced by the amount of taxes paid out. The higher the taxes, the less there remains for the purchase and consumption of goods.

Taxes on consumers are, as we all know, both direct and indirect, and for the great masses of consumers whose families' incomes are less than $2,000 per year, the major burden of such taxation is indirect. The larger part of the taxes they pay are hidden in the prices of the necessities of life which they buy. A recent study has shown that 63% of all taxes collected in this country are indirect or hidden, and are paid by consumers in the prices of goods. Thus, in a loaf of bread, there may be as many as 53 concealed taxes. In the price of gasoline, there may be as many as 116 different taxes.

In a recent study made by the Family Economics Bureau of the Northwestern Life Insurance Company, computations were made of all taxes entering into the retail price of nine staple products, with results expressed in percentages of the prices paid by consumers, as follows:

Gasoline	30.0%	Flour	5.7%
Shoes	9.7%	Bread	7.0%
Silk Knit Goods	11.1%	Beef	8.2%
Cotton Ready-to-wear	10.9%	Pork	8.2%
Woolen Goods	11.6%	Sugar	18.6%

In another report issued from the same source, it was shown that out of the rental paid by tenants, 3⅓ months of the rent money each year goes for taxes from those who occupy houses, and 7 weeks' rental is taken per year by taxes from apartment dwellers.

The burden of taxes of all kinds now amounts to nearly 20% of the total national income. There has been a lot of discussion about the incidence of taxation. Certainly the taxpayer, whoever he is, has his purchasing power reduced. If 63% of all taxes are indirect or hidden, then these burdens fall mainly on consumers. These hidden taxes, estimated at $22,000,000 daily, add to the cost of things we eat, drink, wear and use, reduce purchasing power 12% and amount to $60 per year for every man, woman and child in the United States. These taxes are concealed, yet contained in the prices of the articles purchased. Therefore, any saving made in taxation, leaving more money in the consumers' pocketbook, would mean an increase in purchasing power, active demand for more goods, and, consequently, increases in production, in employment and general improvements of business.

Take the public expenditures for relief as an example. These expenditures constitute an additional burden of taxation and a consequent decline of purchasing power, of production and of employment, and definitely defeat the plan for the increase of national income.

Taxes have now reached the point where they undoubtedly tend to discourage and prevent the extension of industry, and so are now contributing to further unemployment and greater demands upon the state which will, in turn, require greater taxation.

Our tax problem is further complicated by the rise of large-scale political racketeering. In addition to the time-honored purpose of raising revenue and occasionally to accomplish some social or general economic good, such as the tariff and the excise taxes on alcoholic liquors, we have in recent years seen a rapid spread of taxation, not for the purpose of raising revenue, nor even for the purpose of any public interest, but rather as a means of grabbing a special privilege for some kinds of businesses at the expense of other businesses and of the consuming public. I refer specifically

to the chain store taxes now levied in 22 states, and if Congressman Patman's intentions materialize at the next session of congress, we will have a bill that will drive all interstate chains out of existence. Our company operates multiple unit stores in 26 states and the District of Columbia, and is in direct line of attack of this vicious assault, and to us it is most threatening.

None of these chain store taxes produce any considerable revenue. In the state of Colorado, for example, in which the chain store tax issue will be decided on November 8 at the polls, the total revenue from this tax has averaged less than ½% of the state's gross revenue over a period of four years.

In the state of Iowa, total collections in the 1937–'38 fiscal year were $36,900. Such laws are not intended to raise revenue. They are, as everyone knows, measures passed as a result of political pressure at the behest of certain interests to handicap, restrict or eliminate the direct channel of distribution.

There is probably not a reputable economist or tax expert in the entire land who has discovered a sound reason for, or who has at any time advocated, chain store taxes. Every impartial investigation of the comparative efficiency of chains and independents with their wholesale sources of supply has found a balance of advantage in the chain stores from the standpoint of the public. Even the Federal Trade Commission in its monumental six-year study of chains, a study intended to find out whether chains were guilty of unfair competition and whether they were tending towards monopoly, completed in 1932, gave the chains a clean bill of health, and incidentally testified to the important contributions made by them to the public interest. The Federal Trade Commission in its report said:

> "To tax out of existence the advantages of chain stores over competitors, is to tax out of existence the advantages which the consuming public have found in patronizing them, with a consequent addition to the cost of living for that section of the public. That portion of the public which is able to pay cash and is willing to forego delivery service in return for the advantages of lower prices will be deprived of that privilege, generally speaking, although there are exceptions both ways.
>
> "It will also tend toward an arbitrary frustration of whatever saving in cost of production and distribution results from integration of the functions of producer, wholesaler and retailer.
>
> "So, on the whole, the number of people adversely affected by such a tax would constitute a very substantial percentage in comparison with the number adversely affected by present conditions. The graduated tax on chain stores cannot accomplish fully the social ends aimed at by such legislation without producing incidentally these results."

In a more recent study by a committee of experts on taxation, sponsored by the Twentieth Century Fund and completed in 1937, similar conclusions were reached, and a definite recommendation was made that all such special taxes be immediately repealed.

Even the supreme court in passing upon and approving the constitutional rights of the states to pass discriminatory or even prohibitory tax laws, has been careful to observe that such state rights, if exercised, may be neither fair nor sound in their effects on the public. Mr. Justice Roberts delivered such an opinion in May 1931. Again in January 1935, Mr. Justice Cardoza corroborated the same views.

Congressman Patman and other legislators who are sponsoring discriminatory tax legislation have undoubtedly discovered the statistical fact that there are from ten to twelve times as many owners and others dependent upon them (persons, by the way, who are voters), as there are in the chain store channel of distribution. Under those circumstances, it may seem that sponsoring the special selfish interest of a group is a political push-over.

Before Congressman Patman gets through, however, he may hear from another group having even more voters than the entire retailer group.

The women of the country, as you all may have noticed, are taking an increasingly intelligent interest in these efforts to ruin a type of retailing now rendering a useful and efficient service.

The farm organizations of the country are also likely to have something to say about whether one of their principal, as well as most effective, outlets for their products is to be eliminated.

Labor, too, has a vital interest in this store controversy. The American Federation of Labor at its recent convention in Houston, Texas, passed a resolution criticizing the Patman Anti-Chain Store Bill as a discriminatory and punitive measure intended to destroy the chain store system employing 300,000 workers. The resolution closed with the statement that: "The Patman Bill runs in direct opposition to the entire trend of modern industrial development, and of established policy on the part of the public and of organized labor."

The tax system of this country has become extremely burdensome, not only to retailing, but to other branches of business as well. The amounts of taxes collected are high, and may be expected to go higher if our national existence is to be rescued from bankruptcy. Our tax system has also become highly involved, intricate and complicated. It is, indeed, a maze and a mess. As Mr. S. Parker Gilbert, former under-secretary of the treasury, has said, it is "probably the worst tax system in the world." Moreover, it is rapidly growing worse. Drastic remedies are needed, and promptly.

Business men are as courageous and as desirous of holding up their part of our present economic system as the people of any other

occupation or profession. But the present difficulties of keeping a business in successful operation, of meeting taxation's burdens and, at the same time, of having to bear criticisms and attacks for which they may properly disclaim responsibility, is leading many of them to ask, "Where will it end?"

Business conditions are not yet good. Business, itself, is on its knees in a vigorous struggle to maintain its existence, to provide employment and serve its social as well as economic purposes.

I do not suggest that business asks for or needs sympathy, but rather that it is being seriously hindered and prevented from performing its functions properly. Business doesn't ask for crutches—all it wants is elbow room enough to keep at work. The appeal of business must be to the self-interest of the people of this country. If the present system which has made it possible for 25,000,000 families to own automobiles, for all children to gain the advantage of a liberal education, and for the great majority of our people to enjoy a higher standard of living, even during the present years of depression, than found in any other country in the world, if these are not matters of personal concern to the people of this country, then it is unimportant whether the present system of business is to continue or not.

But most of us are unwilling to accept a picture so hopeless in its conclusion. Certainly most of our people appreciate what they have, and are willing to fight, if need be, for the preservation of the system which has made their advantages possible. It is with these people that our business men in general, and retailers in particular, are ready and willing to ally themselves to contribute every possible energy to overcome the present depression and to prepare to make further gains in our economic life for everybody.

One of the necessary steps to this end is the improvement of our taxing system. It requires simplification and standardizing.

It is futile to talk of lower taxes so long as our budgets are unbalanced. Ways and means must be found through government economies, on the one hand, and through increased taxation, on the other, to re-establish a balance of debits and credits. This is elemental and a preliminary to any further improvements that may be made in our taxing system.

Certainly, steps should be taken as promptly as possible to coordinate the various taxing authorities from the federal government down to the smallest hamlet or school district to prevent the present overlap, conflict, competition and confusion that exists. Such coordination is long overdue. Every intelligent person familiar with our taxing system recognizes this fact. The main difficulty seems to be to get enough legislators to institute the changes necessary in this direction.

Probably the best means through which such general improvements in our taxing system may be planned would be to have a

commission, consisting of tax experts representing not only the government and its needs, but also industry and trade, make the necessary studies and then report their recommendations to the public and to our legislative bodies for legislative action. This suggestion is not new or original.

Such a commission, with full authority to cut a straight route through the present brambles of taxation, might be expected to recommend a system of taxation requiring less expense in the preparation of reports, in the computing of taxes and less need for litigation over doubtful points and lower cost of collection. Certainly there should be a more equitable distribution of the burdens of taxation. The public interest as well as business would be greatly served by the complete elimination of a multitude of minor business taxes and fees, which, in the aggregate, yield but little revenue, but which add to the burdens of business life.

Such a commission would, I believe, indicate the need for, and the method of which our present income tax could be made more productive by broadening its base so as to include many more of our citizens as income taxpayers.

A clear analysis of the pros and cons of such taxes as on undistributed profits, on excess profits and on the entire theory now in practice of graduated taxes on corporations would, I believe, lead to their elimination.

It would be a reasonable hope that such a commission might agree with the leading tax authorities of this and other countries that taxes should be levied for revenue solely, and should never be used as a means of serving other purposes.

Finally, we shall never be able to maintain a democratic government on a permanent basis unless all of its citizens participate in its burdens and responsibilities as well as in its privileges and benefits. An enlightened knowledge on what taxes are needed, and for what purposes, with a clear understanding of where such taxes fall, down to the last individual consumer, seem necessary conditions. There is probably no greater weakness in our present system than the heavy burdens that fall upon the masses of poor people and there is no greater tragedy than the fact that these taxes are so well concealed that those who pay them have no realization of their amounts. A careful cultivation of a public consciousness of taxation is an absolute necessity to a sound democracy.

The National Tax Association is an honored and influential institution. It has a splendid record of achievement, not only in the interchange of information concerning taxes and their administration, but also in its promotion of improvements and tax reforms. Its responsibilities are as great as its opportunities. Business men look to this association for the necessary leadership as well as the technical spade work to secure the much-needed housecleaning in our present tax system.

Toastmaster Stone: My friends, I am sure you will all agree with me that we have had a splendid session this evening, one of the most interesting and one of the most helpful I have ever attended. The meeting is adjourned.

(The meeting thereupon adjourned.)

EIGHTH SESSION

WEDNESDAY, OCTOBER 26, 1938, 9:30 A. M.

CHAIRMAN LELAND: It was suggested to me last night that those who are going to take part in the discussion would like to say their pieces immediately after the papers to which their remarks particularly applied.

I have no particular sentiments about that. You can do as you like. We put them at the end so that they might break the ice for more timid people who might care to follow, but if you would rather hear the papers and hear some of the discussion and then talk a little while and then go on, I haven't any objection. Your chairman can leave that to your decision in the most democratic fashion.

The general topic for discussion this morning centers around the federal income tax. When I tried to think of a presiding officer who could be at home here this morning, and who could handle the gathering, I could think of no one better than my good friend C. H. Morrissett, tax commissioner of the state of Virginia. He runs a good income tax in his own state, has a very effective administration, but how such a fine gentleman and such a mild-mannered man can get such good results is somewhat of a mystery. We usually think of tax commissioners as hardboiled gents, twice boiled, but Mr. Morrissett is just the other way. He is a true southern gentleman with all that implies, and a fine tax commissioner. To boot, he is a scholar.

Mr. Morrissett, it is a pleasure to turn over to you these symbols of your authority to use upon your participants as you like.

C. H. MORRISSETT, presiding.

CHAIRMAN MORRISSETT: I appreciate more than I can say the kind references made to me by our president.

In this matter of tax administration in a state having a state income tax, it has been my experience that we tax commissioners have to get and maintain a working knowledge of the federal law. Indeed, we find that a working knowledge of the federal law is almost as important as the knowledge of our own state law. Not a day passes but that we have to go into some question of federal law having its bearing upon the state situation. So I think the program committee is to be congratulated on the topic this morning, "Federal Tax Problems," and we are fortunate in having competent speakers, as we always do. The first subject is, "The Taxation

of Personal Holding Companies." It is still a very, very live subject. On that we are privileged to hear from Mr. Randolph E. Paul, attorney at law, New York City.

THE TAXATION OF PERSONAL HOLDING COMPANIES

RANDOLPH E. PAUL
Attorney at Law, New York City

The unpretentious title "Taxation of Personal Holding Companies" covers a vast range of material. In assigning such a topic for a 20-minute discussion, your chairman may have been motivated by a desire to teach a six-volume lawyer the art of economy in speech; or he may have wished to ease you into this difficult subject by making its title simple. Labels count for little,[1] it is true, but if the label on these remarks is supposed to give my audience any idea that a complete appraisal of personal holding company taxes can be crowded into a 20-minute area, I would be laying myself open to prosecution for running a confidence game. I, therefore, feel a duty to issue a *caveat* at the very outset that my discussion of personal holding companies will be deceptively sketchy, and also that recent tax amendments have pretty well deflated the personal holding company device, so far as tax saving is concerned. In fact, a severe increase in rates in the 1937 act, burdensome and embarrassing requirements as to information returns, attractive liquidation provisions, and other factors, are making personal holding companies an extinct species so speedily that we can here do little more than pronounce a funeral oration and doff our hats at their passing. They are passing away rapidly in the year 1938; and we shall see that they are not being permitted to die in peace.

Personal holding companies have been much in the limelight during the past few years. They drew a special broadside in the 1934 act, which for the first time recognized the failure of the provision designed to prevent the avoidance of surtax by the accumulation of corporate surplus.[2] The new 1934 act provision was continued without much success in the 1936 act even with the undistributed profits surtax as an ally.[3] Personal holding companies were finally exposed in the 1937 hearings as a powerful enemy of the revenue,[4] and a large portion of the act hatched in that year declared an open season upon such companies, domestic and foreign.[5] But it would

[1] *R. H. Stearns Co.* v. *United States,* 291 U. S. 54, 61 (1934).

[2] 1934 act, sec. 102.

[3] 1936 act, sec. 102.

[4] *Hearings Before Joint Committee on Tax Evasion and Avoidance,* 75th Cong., 1st Sess., p. 146; Paul, *The Background of the Revenue Act of 1937,* 5 U. of Chicago L. R. 41, 58 (1937).

[5] 1937 act, sec. 1, amending 1936 act, Title I A; Sec. 201, adding Supplement P to Title I of the 1936 act.

be a great mistake to assume that corporations formed for tax purposes, or legislative provisions aimed at preventing such companies, are only a recent development. From the beginning of income taxation one can trace the formation of small, close corporations designed to minimize the impact of the higher progressive rates of individual surtaxes. A taxpayer having a large income would create a corporation and transfer to it all, or a large part, of his assets. The income would then be taxed at the corporate rate, which would be higher than the normal individual rate, but lower than the individual surtaxes. The taxpayer would declare dividends sufficient to meet his current needs, or make loans from the holding company to himself, and postpone indefinitely the distribution of the remaining surplus, or time its distribution to fall into years of large offsetting losses. In addition, deductions — as for capital losses— might be obtained which were not permitted to individuals under some of the later acts.[6]

In the 1913, 1916 and 1918 acts[7] congress made verbal reply to this device in provisions *completely disregarding the corporate entity and giving the commissioner in certain instances power to tax corporate income directly to the shareholders.*[8] But certain *dicta* in *Eisner* v. *Macomber*[9] seemed, to the initiated of 1920, to insulate the corporate entity as an impregnable fortress which the tax collector could not constitutionally penetrate, and congress turned in the 1921 act to the expedient of imposing penalty taxes *upon the accumulating corporations* to compel the distribution of earnings.

The suggestion has been advanced that congress intended this statute to be so drastic as to strike terror into the hearts of stockholders, — that it was a "bogey—a scarecrow."[10] The difficulty for the government, which taxpayers soon learned, lay in the *subjective* test of taxability, the tax being imposed only if corporate surplus was accumulated for the *purpose* of preventing the imposition of surtaxes upon the shareholders. Such a purpose was almost impossible of proof. The chief sinner against the revenue was the closed or family type of holding and investment company which derived its income from dividends, interest, and profits on the sale of securities. Such corporations were usually able to thwart the

[6] Paul, *The Background of the Revenue Act of 1937*, 5 U. of Chicago L. R. 41, 61 (1937).

[7] 1913 act, sec. 2–A–2; 1916 act, sec. 3; 1918 act, sec. 220.

[8] In view of the gentleness of tax rates at the outset of the income tax— the highest surtax under the 1913 Act being only 6% on the excess of income over $500,000—the danger that individual taxpayers might form or avail themselves of incorporated pocketbooks to escape such taxes now seems rather remarkable.

[9] 252 U. S. 189 (1920).

[10] *Report of Committee of the National Tax Association on Simplification of the Income Tax*, 1927, p. 31.

statutory presumption of interdicted purpose by making partial distributions, and by showing some vague business need for accumulation of the remaining profits.[11] Benjamin Franklin, describing in his famous autobiography how he ceased to be a vegetarian, pronounces man a reasonable being precisely because he can always find a reason for whatever he wants to do. Similarly, imaginative taxpayers, when retaining a corporate surplus, are almost invariably able, with the help of fertile-minded, hindsighted counsel, to advance business contingencies which would justify such a retention. The reasons given may often have been flimsy rationalizations, and (to use in another connection a descriptive phrase of the late Mr. Justice Cardozo) the process of psychoanalysis may thus have spread to unaccustomed fields,[12] but the fact remains that judicial tribunals were convinced, and the prevention of corporate surplus accumulation languished.[13]

For many years the government did not even attempt to enforce these sections in a vigorous way, partly because of its preoccupation with other problems and the difficulties of proof, and partly because the highly penal rates, running as high as 50%, alienated the sympathy of tax officials and made them reluctant to invoke them. Perhaps no other section ever remained in the income tax statute so long and produced so small a crop of litigation. However, in the 1938 act, as you know, section 102 has been somewhat strengthened, although the precise effect of the amendment is by no means clear.[15] And in recent months a more wholehearted effort to enforce the section appears in the reported cases with a better batting average for the government. In fact, had the government in prior years been as successful in enforcing this provision as it had been recently in the *National Grocery* case and a number of other decisions,[16] section 102 and its predecessors might well have been adequate to accomplish the work which the holding company sections are now designed to do.

The fresh approach of classifying certain closely-held corporations as personal holding companies by *objective* tests was first employed in the 1934 act. The problem was to mark out the scope

[11] *Commissioner* v. *DeMille Productions, Inc.*, 90 F.(2d) 12 (C.C.A. 9th, 1937), cert. den. 302 U. S. 713 (1937).

[12] Cardozo, J., dissenting in *United States* v. *Constantine*, 296 U. S. 287, 299 (1935).

[13] As to the failure of this statutory provision see *Report of Committee of the National Tax Association on Simplification of the Income Tax*, 1927, p. 29, calling the section a "useless member of our income tax system."

[14] *Report of Committee of the National Tax Association on Simplification of the Income Tax*, 1937, p. 30.

[15] Paul, *Selected Studies in Federal Taxation*, Second Series, p. 279 (1938).

[16] *Almours Securities Co.*, 35 B.T.A. 61, aff'd 91 F.(2d) 427 (C.C.A. 5th, 1937); *R. L. Blaffer & Co.*, 37 B.T.A. 851; *Reynard Corp.*, 37 B.T.A. 552; *Nipoch Corp.*, 36 B.T.A. 662; *Mead Corp.*, 38 B.T.A. No. 93.

of the new provisions and to define the type of corporate victims which were to be included. Personal holding companies were described as including any corporation (with certain minor exceptions) 80% of whose gross income during the taxable year was received from royalties, dividends, interest, annuities, and (except in the case of dealers) gains from the sale of securities, and more than 50% of whose stock, at any time during the last half of the taxable year, was owned directly or indirectly, by or for not more than five persons.[17] Such a corporation could extricate itself from the holding company surtax if all the shareholders were willing to return, as their own individual income, their *pro rata* shares, whether distributed or not, of the company's adjusted net income. This provision was subject to criticism, however, on the ground that the stockholders would be paying taxes on the entire corporate adjusted income, whereas if the corporation had made an actual distribution of dividends, a distribution of only 80% would have sufficed to avoid the special surtax, since the corporation was allowed 20% of its adjusted net income as an arbitrary deduction.[18]

Of course, laying down rigid objective tests of taxability invariably involves the danger of occasional unforeseen injustice in application, especially for the unsophisticated,[19] and challenges the sophisticated to invent new methods of avoidance. The definition of personal holding companies in the 1934 act was found fairly simple to circumvent. By taking care, for example, that more than 20% of the corporation's income came from sources other than those mentioned in the statute—such as rent—the company could be taken out of personal holding company classification. The ineffectiveness of the provision was intensified by over-generous deductions, by the fact that the rates were still too low to compel distribution, and by the administrative difficulties of assembling returns filed by the company and the stockholders, sometimes with malice prepense, in widely separated districts. For the year 1935, on personal holding company incomes of approximately $115,000,000, the treasury collected surtaxes of less than $2,000,000.[20]

[17] 1934 act, sec. 351(b) (1).

[18] See Lang, *Surtaxes on "Personal Holding Companies" and "Corporations Improperly Accumulating Surplus,"* 13 Tax Mag. 274, 276 (1935); Sherman, *Taxation of Corporations Used to Avoid Taxes upon Shareholders,* 13 Tax Mag. 78, 84 (1935). Another criticism was stated in the *Report of Committee of the National Tax Association on Simplification of the Income Tax,* 1937, p. 31, that in many cases individual returns were made up before the corporate accounts were made up.

[19] *Report of Committee of the National Tax Association on Simplification of the Income Tax,* 1927, p. 10. The same report characterized the drastic rates of the holding company sections as "cracking nuts with sledge hammers" (p. 29).

[20] See Paul, *The Background of the Revenue Act of 1937,* 5 U. of Chicago L. R. 41, 58 (1937), as to domestic personal holding companies; and see p. 49 as to foreign personal holding companies.

The widely-publicized tax hearings of 1937 revealed many instances in which ingenuity in the abuse of personal holding companies had been pushed to new highs. For example, a number of taxpayers employed the device of transferring income-producing securities together with a yacht or a farm to a corporation so that the corporation could do what the individual owner could not do—namely, offset the expenses of the yacht or farm against the income from securities. Sometimes the individual owners of these corporations were able, by paying sufficient rent for the use of the property (more than 20% of the corporation's gross income) to prevent the company from falling into the holding company category. One enterprising taxpayer and his friend owned no less than 12 personal holding companies and two realty companies. These 12 personal holding companies, by playing a veritable game of tennis with the legal title to certain securities, were able in 1935 to claim losses aggregating over $500,000. There were sales from one company owned by the taxpayer and his friend to another company owned by them; there were sales from one company belonging to one individual's group to a company belonging to the other individual's group; there were sales within a group; and finally there were sales that constituted a complete "ring around the rosy," securities being sold by one of these individuals to a company owned by the other, then a like number of shares in the same securities being sold back by two of the other controlled companies.

As a result of the 1937 hearings, a death sentence was pronounced against personal holding companies by the provisions of the 1937 act, which completely re-wrote title I A of the 1936 act. The most significant changes were three-fold: (1) a drastic increase in the surtax rates upon such corporations, now 65% on all undistributed adjusted net income up to $2,000, and 75% on all undistributed adjusted net income over that figure; (2) a tightening of the specifications which classify a corporation as a personal holding company, and of the items which are included in holding company income; and (3) a denial of deductions formerly allowable in computing the undistributed net income. In the case of *foreign* personal holding companies, supplement P of the 1937 act proposed to tax the corporate income directly to the United States shareholders, thus returning to an early disregard of the entity of such corporations. The constitutional difficulties which are supposed to lie across the path of this procedure are probably not as serious as we once supposed. A violation of due process will doubtless be urged against the validity of the provision, but it is a long time since the supreme court has been visibly worried in tax cases about problems of degree like due process.

SECTION 112(b)(7)

In view of the foregoing provisions, the most important thing about personal holding companies at the present moment is their extinction with a minimum of tax cost. The problem here appears to be to dissociate death and taxes. Congress has tried to "smooth the bed of death" by the provisions of section 112(b)(7) of the 1938 act. Very formidable in language and very complicated in arrangement is this new and important section. To summarize it roughly, there is to be recognized and taxed *as a dividend*, upon the complete liquidation of a corporation, only "so much of the gain as is not in excess of his (the *non-corporate* shareholder's) ratable share of the earnings and profits of the corporation accumulated after February 28, 1913." If his portion of the *cash* (including securities acquired by the corporation after April 9, 1938) exceeds his ratable share of the earnings and profits, such excess is to be taxed *as a capital gain*. In the case of *corporate* shareholders (not including a corporate holder of a majority of the liquidating company's stock) there is to be taxed the cash (and securities acquired after April 9, 1938) or the ratable share of the earnings and profits, which ever is the greater; apparently in the latter case the recognized income is taxed as a capital gain, and the corporate shareholder does not get the benefit of the dividends received credit.

This section applies only in case all the distributions in complete liquidation of the company are made *during the month of December, 1938;* hence its interest and importance may be shortlived. But, as so often happens, it is necessary to analyze and study the effects of the provision as thoroughly as though it were going to be with us for the rest of our lives, especially in view of the large amounts of tax liability which may often be at stake. And, of course, there is a possibility, at least if a large number of taxpayers show a desire to take advantage of the section, that its operation may be extended in the next revenue act beyond its present wholly arbitrary period of limitation.

A number of very vital questions must be checked in advance of any attempt to liquidate under the provisions of this section. Otherwise corporations, rushing into a liquidation hastily and congratulating themselves prematurely on the painlessness of their death, may possibly find themselves in a fool's paradise. It is better to ask questions in advance than to have no satisfactory answer for them after the event. Before it is too late every one using this section should ask the following questions:

(1) If the company has contingent liabilities which cannot possibly be entirely discharged during the month of December, would the payment, out of a reserve fund, of such debts subsequent to the month of December when their exact amount becomes definitely ascertained be regarded as a further transfer of property in liquida-

tion, preventing the application of section 112(b)(7)? If the corporation has a claim for a tax refund, which may not be capable of assignment to the shareholders,[21] may the shareholders be denied the shelter of the section if the company receives the refund after December, 1938?

(2) The section contemplates the imposition of the surtax (not the limited capital gain tax) upon that part of any cash distribution (or distribution in kind of securities acquired after April 9, 1938) which is made out of "earnings and profits" accumulated after February 28, 1913. What are such earnings and profits? Is there any substantial danger that a mere unrealized appreciation in value of the corporate assets may be regarded as earnings and profits?[22] And may the term "earnings and profits" used in this section include non-recognized gain on previous tax-free reorganizations? I cannot attempt to answer these questions in a short address, but I can suggest the seriousness of the problem and say that I would not liquidate a corporation under this provision if these problems were presented and the amounts involved were substantial.

(3) Is the property received upon liquidation to be treated as acquired in an "exchange" of the stock surrendered for cancellation, so as to tack together the period for which the taxpayer holds the new assets and the period for which he held the exchanged stock, in computing the holding period for the purpose of later capital gains taxes or deductions? Courts are in conflict upon this point in fairly analogous situations,[24] and no one may prophesy what the supreme court may ultimately hold.

[21] See R. S. 3477; see, however, *Kingan & Co., Inc.* v. *United States*, 44 F.(2d) 447 (Ct. Cls., 1930).

The Conference Report on the 1938 Revenue Bill clearly reveals a legislative intent that the requirements of Section 112(b)(7) may be complied with if proper arrangements are made in good faith for the payment, after December 31, 1938, of unascertained or contingent liabilities; but the Act itself did not specifically incorporate such a provision. See Conference Report 2330, 75th Cong., 3rd Sess., p. 39.

[22] Paul, "Ascertainment of 'Earnings or Profits' for the Purpose of Determining Taxability of Corporate Distributions," contained in *Selected Studies in Federal Taxation*, Second Series, p. 167 (1938), previously published in 51 Harv. L. R. 40 (1937).

The danger of such an interpretation in the present case is perhaps heightened by the fact that Section 112(b)(7), as passed by the Senate, contained a provision that for the purpose of determining accumulated earnings or profits, mere increase in the value of property should not be treated as earnings or profits. This statement was *eliminated* by the Conference Committee, possibly because of a fear that making such a provision in Section 112(b)(7) might cast additional doubt upon the application of the same principle under other sections.

[23] *Ibid.* at p. 185.

[24] *White* v. *United States*, 21 F. Supp. 361 (Ct. Cls., 1937). Cf. *Weaver Co.* v. *Commissioner*, 97 F.(2d) 31 (C.C.A. 9th, 1938), cert. granted October 10, 1938.

(4) Again, let us suppose that the dissolving corporation has a large indebtedness and also has assets which have greatly risen in value, so that if assets were sold to raise the necessary cash for discharging the debt, the taxable income of the company and the ultimate earnings and profits on distribution would be greatly increased. May this result be avoided by having the shareholders assume the company's indebtedness, so that after liquidation they can themselves sell some of the assets, subject only to the capital gains tax, and discharge the debt?

This section was certainly designed as a relief provision, but its value to taxpayers is not apt to be great. Its complications are so baffling that few personal holding companies will take this route to suicide if a more certain method can be found.

SECTION 115(c)

Under section 115(c) of the 1938 act, the time for the liquidation of all corporations (including domestic holding companies, but excluding foreign holding companies) has been extended to *three* years, instead of *two* years, after the close of the taxable year during which was made the first of the series of distributions under the plan. This extension of time is applicable, however, only to cases in which the first distribution is made after December 31, 1937. The 1938 act, in other words, discriminates in favor of those domestic holding companies which begin to liquidate in years after December 31, 1937, by giving to such companies a longer period in which they may liquidate and still enable the shareholders to compute the gain as though it arose from a long-term capital transaction. In view of the fact that the objective of the 1937 act was to eliminate the use of personal holding companies, it seems inequitable thus to treat the laggards in commencing liquidation more favorably than those who commenced liquidation diligently upon the enactment of the 1937 act.

Under the same section any gain to shareholders upon the liquidation of a *foreign* personal holding company is taxed as a short-term capital gain unless the liquidation was completed before July 1st of this year, or in case it is established to the commissioner's satisfaction that due to the laws of the foreign country of incorporation, or to some other reason, liquidation by such date is impossible, then on or before such date as the commissioner may find reasonable. In no event will any extension be granted beyond December 31, 1938.[25] The plan of liquidation must, of course, be a

[25] It is also provided in Sec. 56(c)(2) of the 1938 Act that the Commissioner may grant the shareholders of domestic and foreign personal holding companies extensions of time up to five years for the payment of taxes attributable to the short-term or long-term capital gains derived by the taxpayers from the receipt by them of property other than money upon the complete liquidation of such companies. The Commissioner may require, as

bona fide plan—meaning that the company must actually cease its business activities, and that the purported liquidation must not be a mere disguise masking the distribution of a dividend. If the liquidation is complete and *bona fide*, there is little danger that the distributions might be taxed as equivalent to a dividend under section 115(g),[26] although if there is any fear on this score it may be possible under the new provisions of the 1938 act to apply for and obtain a closing agreement with the government officials on this point.[27]

No doubt many will prefer the apparently greater safety of this liquidation provision. The tax payable will be insurance against a perhaps greater tax under a liquidation under section 112(b)(7), and the basis for subsequent disposition of the property will be cheaply increased.

Without any doubt, the strengthening of the personal holding company sections has gone a long way towards completely eliminating any possibility of tax avoidance through incorporation. The fundamental policy of these statutory provisions is somewhat beyond the range of a tax specialist. True, the sections are complicated,[28] but that is often the least forceful objection that can be levelled against income tax provisions which establish objective tests.[29] Whatever one may think about the justification for holding companies in the banking, utility, and other general corporate and trust fields, there is undoubtedly a vast difference between small, close holding companies, and large, industrial operating companies,—a difference which justifies a differentiation in tax treatment.

The government naturally is interested in the problem mainly because of the very material loss of revenue for which these companies have been responsible. Perhaps even more reprehensible, from a broad social standpoint, is the serious discrimination and inequality in tax burden formerly caused by holding companies as between persons who availed themselves of this device and persons who did not happen to be so astutely advised.[30] Equality of taxing

a prerequisite to such extensions, a bond in an amount not exceeding twice the amount with respect to which the extension is made.

[26] Section 115(g) was not, apparently, designed to apply to a situation involving a *complete* liquidation of all the stock of a corporation; Rudolph Boehringer, 29 B.T.A. 8, aff'd without opinion, C.C.A. 3rd, April 27, 1936. Some cases go even further and hold that Section 115(g), or its counterpart in previous statutes, does not apply even where there is only a *partial* liquidation. See Pearl B. Brown, Exec., 26 B.T.A. 901, aff'd 69 F.(2d) 602 (C.C.A. 7th, 1934), cert. den. 293 U. S. 570 (1934); *Hyman* v. *Helvering*, 71 F.(2d) 342 (App.D.C., 1934), cert. den. 293 U. S. 570 (1934).

[27] See sec. 801, 1938 act, amending sec. 606 of the 1928 act; T.D. 4855, C.B. 1938-2, p. —; Mim. 4821, C.B. 1938-2, p. —.

[28] Angell, *Tax Evasion and Tax Avoidance*, 38 Col. L. R. 80 (1938).

[29] Paul, *Selected Studies in Federal Taxation*, Second Series, p. 1 (1938).

[30] *Studies in Current Tax Problems*, Twentieth Century Fund, pp. 38, 50-51 (1937).

burden could clearly best be approached, and at the same time double taxation avoided, by boldly disregarding the corporate entity of all such companies and taxing their undistributed profits as though actually received by the shareholders — the approach used in the earlier acts, and revived to a limited extent in 1937, with respect to foreign holding companies.[31]

Fear has often been expressed (sometimes in language more suggestive of the classic cracker barrel than of objective economic investigation) that the personal holding company sections may ensnare operating companies formed for the purpose of convenient financing, or other legitimate objects, rather than with any actual purpose of tax avoidance. No doubt there are cases in which this is true. The criticism is by no means new. The secretary of the treasury himself opposed the insertion of section 351 into the 1934 act on the ground, among other things, that "the proposed legislation would seem improperly to include within its scope certain legitimately organized corporations, such as the corporations formed by the beneficiaries of an estate to facilitate the sale and distribution of its assets."[32] But it is well to discard perfectionism and to face realistically the fact that no tax provision can ever work universal economic justice,[33] and that the alternative of general legislation is frequently a choice of two evils. And if there is any legitimate business reason for the particular corporation, it can easily avoid these penal surtaxes *by distributing its income to the shareholders*—even by so doing after the close of the taxable year, under the deficiency dividends credit provision contained in the 1938 act.

I realize that many things—perhaps the most important things—have been left unsaid in this rambling discussion. The only really crucial point is the desirability of immediately putting personal holding corporations to death, at least where they do not have an unduly large surplus. True, these forms of corporate legerdemain provided such a fascinating game that many initiated tax technicians cannot view their abolition without a real sense of loss. And the taxpayers who formerly benefited by such companies will suffer a cruder and perhaps more solid form of loss. In a few situations such companies may still be useful regardless of the lack of tax advantages. For example, the testamentary disposition of an indi-

[31] See *Report of Committee of the National Tax Association on Simplification of the Income Tax*, 1937, p. 28.

[32] See statement by the acting secretary of the treasury regarding the preliminary report of a subcommittee of the committee on ways and means, 73rd Cong., 2nd Sess. (1933); see Sherman, *op. cit.*, note 18, p. 47.

[33] See *Report of Committee of the National Tax Association on Simplification of the Income Tax*, 1927, p. 4. See *Purity Extract & Tonic Co.* v. *Lynch*, 226 U. S. 192 (1912); *Ruppert* v. *Caffey*, 251 U. S. 264 (1920); *Tyler* v. *United States*, 281 U. S. 497 (1930).

vidual's property, and the problems of ancillary administration and transfer upon his death, can often be greatly simplified through forming a holding company to own his assets. Occasionally such companies may also be desirable to siphon off part of an operating company's assets and protect them, to a limited extent and in various ways, against the hazards of an uncertain business. But there can be little doubt concerning the general conclusion that in most instances the extinction of personal holding companies does not call for any bitter mourning.

CHAIRMAN MORRISSETT: When we began this morning, President Leland stated that some of those who desired to discuss these papers thought that it would be better to let the discussion follow immediately after the reading of the respective papers, instead of postponing the discussion until the end of all three papers. In those circumstances, the chair knows nothing to do except to ascertain the sentiment, and so now the chair will entertain a motion in order to ascertain that sentiment, to the effect that the discussion will follow immediately each paper. Is there anyone desiring to make such a motion?

J. W. OLIVER (New York): I make such a motion.

(The motion was duly seconded.)

CHAIRMAN MORRISSETT: The motion has been made and seconded. Is there any discussion? There being no discussion, the question will be put. As many as are in favor of letting the discussion follow the reading of each paper, will please say, "Aye."

(Ayes.)

CHAIRMAN MORRISSETT: Opposed, "No."

(None.)

CHAIRMAN MORRISSETT: The ayes have it. The floor is now open to a discussion of Mr. Paul's paper on the taxation of personal holding companies. May I suggest that those desiring to discuss this subject will speak in a loud voice and will give their names to the reporter?

GEORGE H. FOSTER (District of Columbia): Mr. Chairman.

CHAIRMAN MORRISSETT: It gives me pleasure to present Mr. Foster, attorney, department of justice, Washington, D. C.

MR. FOSTER: I want to state first, gentlemen, that we three who were expected to lead the discussion got together yesterday and we thought that any stated form of papers that we might present would

be better presented by each one of us taking one of the original papers to reply to, and apparently because Mr. Paul's paper was addressed to dying business, they thought perhaps I could best talk about a dying business, so I was asked to make such comment as I could on the question of taxation of personal holding companies.

Discussion of Randolph E. Paul's paper.

GEORGE H. FOSTER
Attorney, Department of Justice

Mr. Paul has emphasized the fact of the death of personal holding companies. May we hope that his surmise is correct. To all interested in honest, scientific taxation, nothing should afford more comfort than knowledge that one great agency for evasion and avoidance of tax burden has been destroyed.

As Mr. Paul said, the possibility of tax avoidance through the medium of the incorporated pocketbook was early recognized. In the Civil War Income Tax Act this fact was recognized and provision made for the taxation of shareholders on the profits of the corporation. That act ran its course without serious question of the constitutional right of the government to so tax. The question of its constitutionality was overlooked in that act as was the question of the right of congress to impose an income tax on the income from money invested in real or personal property. That question, as you recall, defeated the 1904(?) income tax act and made necessary the sixteenth amendment to permit of federal income taxation. The first and indeed all income tax acts since the sixteenth amendment have contained provisions designed to prevent the defeat of the intention of the act to tax current income currently. Under the earlier acts the rate being law there was not so great an incentive to defeat the intention. Later, when the rates rose, the desire became all too popular. And this was thought to be cured by the heavy penalty surtax on the corporations accumulating surpluses to avoid surtaxes on shareholders.

It is true that for a long time no apparent use was made of the provisions of the taxing act. But this is a point for all taxing officials to notice—too drastic penalties defeat the end. The judicial reviewing bodies, aided by the fertile-minded, hind-sighted lawyers that Mr. Paul referred to, it was thought, would defeat the provision if it came to a sharp test and the bureau of internal revenue entertained great doubt as to the validity of the act due to the death of *Eisner* v. *Macomber*, used the provision as a club to force settlement of disputed cases. While the provisions did not directly produce much by way of surtax, it undoubtedly did produce a somewhat larger distribution of dividends.

However, the great delay — 1921 to 1938 — in securing supreme court sanction of the provisions, with the consequent use and growth of personal holding companies was not the fault altogether of the taxing authorities.

A test case was made in the United States Court of Claims—*Williams Investment Company*—about 1929, and that court sustained the constitutionality of the provisions of the 1926 act. That case was not taken to the supreme court. The sole stockholder being in poor health would not let his attorney take the case to the supreme court, saying that he did not want to die in tax litigation with his government.

The government later was successful in the second circuit and the taxpayer petitioned for certiorari and the government was entirely agreeable to a decision at that time, but the supreme court declined to take the case.

It was therefore not until last spring that the supreme court met the issue squarely and it then laid down the law in such a way that we can, I think, confidently expect that the provisions of the 1938 act will make accumulations for the forbidden purpose altogether unavailing.

But in the meantime all the evils of the evasion had been exposed and drastic legislation enacted to defeat it. The 1936 act with its harsh taxation of undistributed profits was the result. That act has now been changed so that today we can look at this type of evasion as an interesting bit of history.

As Mr. Paul has said, the 1938 act will go far to end personal holding companies. The slight differential in tax upon corporations with over $25,000 net income which withhold distribution will take care of all legitimate business needs for reemployment of corporate profits and section 102 should be invoked now with confidence to the end that such tax evasion or avoidance will end.

Section 102 has been changed to make it more appropriate to the crime and will probably be wholly effective.

For the purpose of a discussion of the subject further, I think it would be better that any questions asked from the floor be answered from the floor or by Mr. Paul, as I am sure that questions will be asked that I cannot answer relating to the burial of personal holding companies.

CHAIRMAN MORRISSETT: Now the floor is open for further discussion of the subject of taxation of personal holding companies, under the rules just adopted. The chair will be glad to recognize anyone who desires to speak on this subject.

J. W. OLIVER (New York): I am interested in the question of dissolution under section 115(c). I would like to ask Mr. Paul if he concurs in my reading of that section in which congress has

given an opportunity for the stockholders of a personal holding company, dissolving under that section, to have their pie and eat it in the current earnings of the year of dissolution, they are not paid out in dividends prior to dissolution, escape the regular dividend tax and become just a part of a normal capital gain?

MR. PAUL: I think they become a part of the normal capital gain if there is a complete liquidation. I think that section 115(c) was designed originally to encourage early liquidations, and that is one of the encouragements.

I might say in addition that when that provision was first put into the 1936 tax it was represented to congress that the treasury would derive great revenue and I know of one case where a tax was promised if the provision was changed of about $20,000,000. The 1934 act had not given the benefit of section 117 to corporate liquidations and the 1936 act was deliberately designed to accomplish this result and increase the revenue.

CHAIRMAN MORRISSETT: Is there anyone else who desires to discuss this subject? If not, we may proceed to the next paper, "The Taxation of Corporate Holding Companies." We regret very much to be compelled to say that Mr. Godfrey N. Nelson, secretary of the New York *Times*, New York, who was to be with us this morning, found that he could not come. He says, "The worst has happened, my presence at Washington on the morning of October 26th is unavoidable." For that reason Mr. Query, our secretary, has very kindly consented to read Mr. Nelson's paper, and we are very glad of the privilege of having Mr. Query read that paper.

SECRETARY W. G. QUERY: All I ask is that after I read it that you won't direct your questions to me. (Laughter)

TAXATION OF CORPORATE HOLDING COMPANIES

GODFREY N. NELSON
Secretary, The New York *Times*

The subject assigned to me, the Taxation of Corporate Holding Companies, lends itself to a broad scope of discussion. Such treatment of it, however, calls for the inclusion of not only taxes to which corporate holding companies are subjected, but of considerations of origin and utilization to which the taxation of such corporations may be directly or remotely related. I shall discuss the subject briefly in its broader aspects.

Unlike the personal holding company, the corporate holding company bears no special surtax. Nor is the surtax with reference to accumulating surplus, imposed by section 102, unequivocally a tax

upon the corporate holding company. The new statutory declaration that the *fact* that any corporation is "a mere holding company" is *prima facie* evidence of a purpose to avoid the surtax upon its shareholders *now shifts* the burden of proof to the corporation to show that earnings have not been accumulated beyond the reasonable needs of the business. But this is a mere inference or presumption, which can be overcome by a preponderance of evidence to the contrary.

Operating parent companies are subject, of course, to the corporate normal tax upon their incomes from operations like other corporations, but operating income of a subsidiary, when transmitted to the parent company, suffers an additional tax to the parent to the extent of 15 per cent. For the tax upon undistributed profits, however, intercompany dividends are not reduced by the 85 per cent deduction allowed for normal tax purposes. As to other federal taxes, pure holding companies, not deemed to be doing business, are exempt from the capital stock tax and the excess profits tax.

Thus it would appear that the corporate holding company is comparatively free of discriminating or prejudicial taxation except for the partial double tax upon distributed earnings of a subsidiary, the *prima facie* evidence provision in respect to the surtax on unreasonable accumulations of surplus, and the declaration of the entire amount of intercompany dividends for the tax on undistributed profits. A broader examination of the subject and its attendant phenomena, however, gives rise to some apprehension for the continued and undisturbed use of this form of corporate organization.

The legislative trend in taxation for some years past has been definitely adverse to the holding company, caused by an untoward influence from which the corporate holding company has not been immune. This attitude of opposition, it will be noted, however, has not been shared by the treasury. Legislative committees, on the other hand, in their quests for methods of preventing avoidance of the revenue laws appear to have been under the delusion that corporate holding companies enjoyed unwarranted taxation privileges. Perhaps because such corporate groups are generally representative of so-called "big business" the stigma of tax avoidance has attached itself to this form of business association.

While no major movement has been undertaken by way of taxation with a view to disintegrating *all* forms of the holding company, such as the extreme surtax now imposed upon the personal holding company, changes have been and are being wrought in our taxing and economic systems which are aimed directly or indirectly at this type of business ownership.

The revenue act of 1932 levied a new and additional tax of three quarters of 1 per cent on the net income of holding companies for the privilege of continuing the use of the consolidated form of return. The National Industrial Recovery Act increased the tax to

1 per cent. Simultaneously with the adoption of the surtax on *personal* holding companies the privilege of filing consolidated returns was abolished, except as to railroad corporations, by the revenue act of 1934. Another important change in the taxation of corporations, but directly aimed at big business, was the adoption of the principle of progressive income tax rates. Of still greater importance to the welfare of the corporate holding company, however, is certain federal legislation, either already on the statute books or now awaiting action by the congress.

Although the Public Utility Holding Company Act of 1935 is not a revenue measure, to the extent that it *in effect* deprives security holders of their equities in such companies, the act is tantamount to an exaction upon private property.

In the next session of congress a bill will be acted upon which seeks to impose upon chain store groups, made up to a large extent of corporate holding companies, a tax so extreme as to threaten the existence of every large chain throughout the country.

There is also awaiting the congress a bill seeking to effect a federal licensing of corporations engaged in interstate commerce, which conveys, according to its proponents, the avowed purpose of bringing about "a real distribution of the wealth of the country," by regulating interstate industry, by providing profit-sharing plans for employes, and by compelling the distribution of corporate dividends. These objectives, if enacted into law, will lead inevitably to the imposition of additional federal taxes upon operating parent companies and subsidiaries engaged in interstate commerce.

The proposal to license corporations engaged in interstate and foreign commerce is concededly aimed at "big business," a term which has come to be regarded as almost synonymous with business conducted by the corporate holding company. The bill is in fact largely an extension of the governmental powers already conferred by the Sherman Anti-Trust and Clayton Acts, the Federal Trade Commission Act, the Labor Relations Law and the Securities Act, with added restrictive measures affecting corporate fiscal policies.

At least the corporate holding company did not have its origin in any scheme of tax avoidance. It was devised long before the incidence of the present income-tax system. It probably first derived its general statutory sanction under state laws in anticipation or in pursuance of the adoption in 1890 of the Sherman Anti-Trust Act. While holding companies had been previously employed by railroads for nearly sixty years, formed by special acts of legislatures, New Jersey, in 1889, was the first state to confer upon corporations by a general statute the power to hold stocks of other corporations. New York enacted a similar amendment in 1892, and other states followed these examples.

It seems paradoxical that while certain states were attracting the incorporation of corporate holding companies the so-called "trusts,"

operating under trust agreements, were at the same time being prosecuted under state statutes, or the common law of the states, as monopolies and combinations in restraint of trade. Some of the larger trusts, in fact, were reorganized as holding companies.

Although not immune from prosecution for exercising monopolistic control over industry, the holding company continued in favor as a legitimate form of industrial organization. And it is noteworthy that the holding companies that were prosecuted as monopolies were not found illegal because they were holding companies but because they had effected restraints of trade.

In spite of the fact that litigation involving charges of violation of the Sherman Act was pending in the courts in 1909, the most important of which was a case against a New Jersey holding company, the special excise tax on corporations, enacted August 5, 1909, expressly exempted dividends received by corporations upon stock of other corporations. This exemption seems reasonably to evidence the fact that no prejudice then existed against the holding company.

Upon grounds unrelated to the excise tax on corporations, President Taft recommended to congress in 1910 the enactment of a federal corporation bill, intended to limit holding companies to purposes approved by a proposed federal corporation commission. This program having failed of adoption, President Wilson submitted in a message to congress on January 20, 1914 a proposal by which the formation of holding companies should be prohibited.

President Wilson's plan culminated in the enactment of the Clayton Act in 1914 and in the creation of the Federal Trade Commission, which body, at the instance of the United States Attorney General, is vested with powers of investigation of corporations alleged to be violating anti-trust laws. The proposal to prohibit holding companies, however, failed of enactment. The corporation's right to acquire and hold stock of other corporations, or even to form subsidiaries, was not restricted, provided that such acquirement or formation did not "substantially lessen competition." The existence of the corporate holding company had not been otherwise threatened.

In the meantime, the question arose under the revenue act of 1913 as to the taxability of the earnings of a subsidiary corporation where the earnings, as a general accounting practice, had been taken up on the books of account of the parent company. The treasury department ruled that such income was taxable to the holding company as well as to the subsidiary regardless of the fact that the subsidiary had retained the earnings and used them in making extensions and improvements in furtherance of its business.

The taxpayer's submission to double taxation of the earnings of subsidiaries under the earlier acts was no doubt due to the fact that the tax rates were extremely low and that the amounts of taxes

involved did not justify bringing the question before the courts for a judicial determination. With the advent of the War Excess Profits Tax, in the calculation of which invested capital became an important factor, it was found to be to the advantage of the government to prescribe the consolidated form of return.

Accordingly, under the revenue act of 1917, the treasury department ruled, without specific statutory authority, that the tax should be imposed upon the "true net income" and that invested capital should be that of "a single business enterprise" even though the business was operated through more than one corporation.

In order to prevent the overstatement of invested capital, a purely statutory term, the treasury recognized that the consolidated form of return must be adopted. The method implied, of course, the allowance of losses as offsets against incomes of the members of affiliated groups but this was unavoidable. In order to commit a group to the true invested capital it was necessary to accede to the taxation of only the true net income.

It was advisable, therefore, that the consolidated return be retained so long as the excess profits tax was predicated upon the actual—as distinguished from a merely declared—invested capital. The excess profits tax having terminated at the close of 1921, the revenue act of 1924, at the instance of the senate finance committee, provided that "the commissioner may, and at the request of the taxpayer shall" consolidate the accounts of situations similar to those specified in the 1921 act. The option thus granted to file consolidated returns was retained in the acts of 1926 and 1928, with limitations as to certain affiliations effective in 1929, not applicable to holding companies. And subject to the additional taxes already mentioned, the option continued under the 1932 act and the National Recovery Act.

In effect, however, the government has reserved to itself the right to impose upon business groups principles which are equivalent to a consolidation. By provisions of section 45, which first appeared in the 1928 act, if the net income of a controlled taxpayer is understated the commissioner of internal revenue may make such distributions, apportionments or allocations between the controlled taxpayers constituting the group as he may deem necessary in order to determine the true net income of each controlled taxpayer.

Although the right to file consolidated returns has been denied to industrial holding companies since 1934, section 45 has been retained in subsequent revenue laws. It has been ruled under this section that a purely holding company, whose activities were confined to financing constituent companies, one of which was a foreign corporation, comes within the term "trades or businesses" as used in that section. Thus the government still has the right to impose the equivalent of the consolidated form of return where it is to its advantage to do so.

The underlying purpose of section 45 is, of course, to guard against tax avoidance by making certain that an amount no less than the *real* net income of a corporate or other group is subjected to tax. But tax avoidance is sometimes construed to mean an avoidance of the maximum amount of tax where the taxpayer's method produces a lesser amount. Under the excise tax, for example, in the case of wholly owned subsidiaries, operating as separate units, each performing processes in the course of production, the excise is imposed on the market value—as against the subsidiary's value—of materials or partly finished products transferred from one plant to another in the course of manufacture. Not only is the common ownership disregarded here but, in effect, the government rewrites the arrangements as between the separate operating units; nor does this take into account the possible evil of pyramiding the tax within the business unit.

On the other hand, in a similar situation, under laws governing the relation of debtor and creditor, separateness of corporations is not always recognized. A holding company may be held liable for the debts of constituent companies. Where, for example, a parent company caused the incorporation of a subsidiary, owned most or all of its stock, financed and exercised control over it, both companies having common directors, the subsidiary being merely a department of the parent company, if the subsidiary has been used as an instrumentality of the holding company's stockholders, the holding company is liable for the obligations of the subsidiary.

The legal fiction of distinct corporate existence is here rejected because, to hold otherwise, might injure one who had dealt with the subsidiary. It follows that taxes imposed on the subsidiary, assessed as though the parent company was unrelated, become an obligation of the parent. It would seem that uniformity of treatment in these relationships could be more nearly accomplished if the industrial holding company and its subsidiaries were dealt with *for tax purposes* as a business unit.

I stated that the treasury had not been unfriendly to the corporate holding company. In December, 1933, a subcommittee of the committee on ways and means of the house of representatives made a report on the revision of the revenue laws, the main object of which was to discover methods for the prevention of tax avoidance. Briefly stated, the subcommittee recommended that permission to affiliated corporations to file consolidated returns should be withdrawn.

The ways and means committee then afforded the treasury an opportunity to present its views with respect to the subcommittee's recommendations. Mr. Morgenthau, then acting secretary of the treasury, accepted the committee's invitation and he, based upon the treasury's experience in the administration of the provisions proposed to be altered, made certain counter-proposals.

Mr. Morgenthau approached the proposals of the subcommittee from exactly the same point of view as had been adopted by the committee. He affirmed the statement that the income tax law should be revised to eliminate loopholes. "Moreover," he said, "particularly in these times, legitimate business transactions should not be impeded by being driven to take uneconomic forms."

The secretary's statement on the subject of consolidated returns is not only a recommendation, it is a comprehensive and authoritative brief on this important topic. Until the right to file consolidated returns has been restored to corporate holding companies this able review of the subject should be read periodically to every federal legislative body having taxation under consideration. If I may, I shall refresh your memories by reading extracts therefrom:

> "Business men and their professional advisers, the lawyers and accountants, have long recognized that the one way to secure a correct statement of income from affiliated corporations is to require a consolidated return, including therein the income and deductions of the parent and every subsidiary, with all intercompany transactions eliminated. Such a consolidated statement is simply a recognition of the actual fact that the separate corporations, though technically distinct legal entities, are, for all practical business purposes, branches or departments of one enterprise. This fact has been so thoroughly established for many years that many affiliated corporations today would find it a practical impossibility to determine the income and deductions of any one member of the group. . . .
>
> "The principal reason given in the sub-committee's report for the abolition of consolidated returns is that this would prevent the loss of one subsidiary from being absorbed by the income of another or of the parent. For reasons already stated, this result is not likely to follow as a practical matter. Subsidiary corporations now showing losses in separate statements, could arrange, by intercompany contracts and by a readjustment of accounting methods, to obtain a fair share of the profits of the affiliated group. There is no way to prevent the bulk of such contracts because the treasury cannot hold that a contract which enables a company to make a profit is necessarily unfair or evasive. Moreover, full recognition of inter-company transactions would often result in deductible losses as well as taxable gains. The fact that consolidated returns have been regarded as absolutely essential to check these practices in the past is sufficient basis for the belief that these evils will recur in the future.
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> "For these reasons the department believes that the abolition of consolidated returns might well be a backward step, which would result in little, if any, additional revenue. On the other

hand, there are considerable savings to the treasury, as well as to taxpayers, in the present arrangement. The administration of the law is simpler since it conforms to established business practice. The treasury needs deal with only one corporation, the parent. On the taxpayer's side, the requirement of separate returns would cause largely increased expense to set up separate sets of books for tax purposes, an undesirable result in itself. The present law permits a return in accord with business practice, and gives the treasury broad powers to make the necessary rules and regulations to prevent escape from the tax. In the judgment of the department, the law should not be changed in this particular."

How the congress could have acted contrary to these convincing arguments would be hard to understand except for one little sentence in the committee's report, reading: "In the past, when any corporation could carry forward a net loss from one year to another, the consolidated group did not have such a great advantage over the separate corporation. Now that this net-loss carry-over has been denied, the advantage of the consolidated return is much greater on a comparative basis." Since "two wrongs do not make a right," both wrongs should be corrected. Until the net loss carry-over provision is also restored in our revenue laws, income taxes will be imposed not on the true net income but on an artificial income.

The importance of the corporate holding company in our economic system needs no affirmance. Operating parent companies and affiliated corporate groups, employers of labor in vast numbers and mass producers of the things that make for national wealth, have become an integral part of our industrial mechanism. Restrictions upon the corporate holding company, such as that of "excluding the power to hold stock of other corporations," unless that power exists at the time of enactment, as contained in the federal licensing bill, may not destroy industry, but they will undoubtedly materially arrest its progress.

The threatened tax upon chain stores is also a sad commentary upon American business enterprise because, if enacted into law, the taxes to be imposed under it will be prohibitive in amounts. The grievance against the chain store system seems to be that it presents competition so keen that it must be destroyed. We prosecute under the anti-trust laws in order to promote competition and we tax to suppress it. Indeed this is a strange use of the taxing power.

CHAIRMAN MORRISSETT: We all appreciate Mr. Query's reading of that paper.

Now we are ready for a discussion of the paper, and it gives me great pleasure to present M. E. McDowell, tax department, Standard Oil Company, New York City.

M. E. McDowell (New York City): I am sure that the author of this paper would be very happy, since he wasn't able to come and present it himself, to know that it was so ably presented. But after all, the National Tax Association has gotten to expect that kind of a job from Mr. Query.

I am sorry just the same that this group didn't have the opportunity of seeing and hearing and meeting the personality behind this paper. In my estimation, there isn't a man in this country with any kind of tax training, legal, accounting or otherwise, as keen in following the developments of federal and other types of taxation as Mr. Nelson, and of course, because of his position with the New York *Times*, he enjoys a particularly useful place to use that knowledge and to strike, as he frequently does, at the hypocrisies of the tax laws, and there are many of them.

I talked to him just before I left New York, and got a copy of his paper, and was commissioned by him to bring his very deepest regrets to this group on his inability to get here. He is trying a tax case, and he couldn't get an adjournment. He wanted to let you know that he would have been here if he could have arranged it.

I suppose that I am a pretty good fellow to pick out to make some few comments here before the discussion, and I am going to make it brief because I have also seen the paper that is to come next and the personality behind that paper is here.

Well, when they ask me to comment on the taxation of holding companies, I am just the fellow to come to, because for a number of years now I have had to live with a good-sized holding company, to make excuses for it and to watch the various attacks on it made under the tax laws and also to see some of the mistakes that apparently are made by a fairly shortsighted policy on the part of government taxation in regard to this type of company.

Of course, Mr. Nelson's paper here opens up the whole question, the fundamental question, as to the rightness or wrongness of this kind of a corporate set-up. We could spend the rest of the day, and then some, discussing that problem.

The more vigorous attacks under the tax laws have been made so far against specific types of holding companies. First we have set off over here a personal holding company. You have just heard the requiem sung over that extinct dodo. Then over here we have passed a public utility law and entirely outside of tax laws we have begun to take care of this iniquitous thing in the public utility field, the holding company, you know, the kind that started here (indicating), and came down here and over here and then tied up here and went over here. You have seen them. So this type of holding company with its sins is apparently on the way out.

Then another type is being segregated for a specific attack, and that is the holding companies that run chain stores or have many subsidiaries in different states that run chain stores, and I think

the most adequate statement as to that is contained in Mr. Nelson's paper. I am going to read you again just the last paragraph of his paper, which to me is a beautifully succinct statement of the whole thing in a few words:

> "The threatened tax upon chain stores is also a sad commentary upon American business enterprise because, if enacted into law, the taxes to be imposed under it will be prohibitive in amount. The grievance against the chain store system seems to be that it presents competition so keen that it must be destroyed. We prosecute under the anti-trust laws in order to promote competition and we tax to suppress it. Indeed this is a strange use of the taxing power."

That is a potent paragraph, and it seems to me to be almost an entire answer to the specific use of taxation to accomplish other than tax results in the case of holding companies involved in the chain store set-up.

But the normal business parent company is still in a last position. This is the group of companies that as yet has only been interfered with by the upstream dividend tax and which now has been thrown under a presumptive danger under section 102. Various things have happened to us We have been denied our right to file a consolidated return, and just a little comment on that: it was to the government's advantage, of course, to have individual returns rather than consolidated returns, from affiliates in one group, when the loss of one company could not be charged off against the profits of another as the company in the consolidated return, when the carry forward of net losses was still in the law. Then the privilege of filing consolidated returns having passed for the holding company set-up, within a very short time the government adopted a new type of taxation, surtax on undistributed profits, and these same groups that because of their failure to file consolidated returns, helped the government's income, immediately hurt the government's income because each individual member of this truly integrated income tax unit, the type of business holding company I am speaking of now, could retain at the 7 per cent rate at least 10 per cent over the allowed amount of its surplus, and spread a 7 per cent tax over the great aggregate of these retentions in each of the individual subsidiaries, whereas if the consolidated picture had still been in existence, no such retention of surplus would have been possible. So you see, the limitation of the consolidated return in so far as the long-range raising of revenue for the government went, backfired almost immediately as soon as we got the surtax.

You may say, "Well, there are a great many sins that I would like to talk about in the case of the business holding company. I think it is wrong, and a great many people in the high places passing tax laws think it is wrong." On the other hand, just to

revert for a moment to our particular business, our business is getting crude oil out of the ground wherever we find it, transporting that crude oil to the nearest available refining place, by pipe line and tank car and steamer, refining it, again distributing it to the available market and putting on the market a great myriad of the products of petroleum.

We have gasoline for your tank and lubricating oil for your motorboat and your industrial machines, and all the way down the line to the specialty products. Flit for your flies, and Mistol for your post-nasal cavity, and even Nujol.

Our business is an integrated business of getting the oil out of the ground and eventually getting it into an available product.

It is quite obvious that it is advisable that the various elements of that business are run by various types of trained personnel. The man who is a good fellow getting the oil out of the ground doesn't know very much about the running of a refinery or the running of a research laboratory. The fellow who manages a fleet of tankers, subject to the peculiar laws and vagaries of the Admiralty law doesn't have to know very much about the production of crude. The Lord knows that the salesman that puts the product into your car and mine is an entirely different person and doesn't care very much about the earlier steps by which he got his product. It is better that these companies be separately incorporated to take care of each of those elements of the business peculiar in their nature. It is human and natural that if you can have a president of a refining company, a president of a pipeline company, a president of a producing company and a president of a sales specialty company, he feels a whole lot better about it than if he is just the manager of that department of one big company. He works better for you. Furthermore, even in the field of state taxation, it is very much simpler to go to any of you commissioners with the company doing a particular business, and say, "Now here, you test our prices in at the top and our prices out at the bottom and then you look at this business alone," and we don't have so much trouble with allocating world-wide business down to your particular state.

There are many reasons why it is perfectly obvious that these elements of the business should be set up that way. At the same time, it is equally obvious also that those various elements of the business should not be separately owned by all the underlying stockholders, that there should be some kind of a coordinating effort there. For instance, if our company at the present time were forced to be eliminated as a holding company, all of you who have stock in that particular company would thereafter be given 4½ shares of the stock of a producing company in Oklahoma, 2.6 shares of a pipeline company in the midcontinent, 8.3 shares of a steamship company operating tankers, 4.6 shares of the two companies producing oil in Mexico, and in that case, of course, since January 6th

of this year, your stock would be worthless because those properties have been confiscated. Then you would find that the federal tax law had been changed this year so that the worthlessness of stock is just the same as a voluntary sale on your part and you would be limited to the limitation on capital losses in that case.

In other words, I could go on down the line to the fragments of stock in foreign businesses, domestic businesses, particularly implemented businesses, each subject to its own business risks, and I am sure you wouldn't like that kind of an investment at all.

I am merely throwing these things out, not because you may agree with them, but because we think it is perfectly logical and perfectly good business to have our company set up in that particular form.

I have said a good many times to the tax authorities as these various sections came along, "Well, that is where that is going to hurt us and that is where we don't think it is right." Usually they say, "You are not the fellow we are trying to get." That is why, so far, the argument on holding companies has forced the taxing penalties out into these particular fields or types rather than blanketing all holding companies. If they can segregate the personal holding companies with their own sins, they are the fellows they are trying to get, and that is all right. If they can drive the utilities over here (indicating) and clean them up, that is all right. But it takes a genius to draw a provision in a tax law that fails to get the good fellows with the bad. Therefore, it seems to me that we can tie this whole discussion up in that if we in business keep on insisting that taxes should be levied for revenue only and that the reform element in taxation should be eliminated, that these catch-all provisions which get perfectly logical set-ups and make it difficult to operate them, and which may eventually lead to their disintegration can be eliminated and avoided. If we keep fighting along those lines, we can do as has been pretty well done in the federal law, and as Mr. Paul's particular illustration points out, segregate particular problems in particular sections, and successfully take care of them, rather than to spread-eagle into tax laws the penalty sections which penalize the good with the bad, the logical with the illogical.

Those are my comments from a practical point of view, a defense if you please, and a practical application of a paper that Mr. Nelson has given us, and which, incidentally, like all these papers, ought to be taken over into your study with a pair of slippers and a pipe and an easy chair and studied to get the best out of it.

Mr. Paul didn't tell you that at the tail end of his paper there are four pages of accurate annotations as to where his material came from, the sections he refers to, articles from which it can be expanded. That kind of research work is the kind we get at these conferences that is worth while, and that is why the annual pub-

lished proceedings of these meetings back on your library shelf for just that kind of reading later provides, in my estimation, one of the finest bits of research and has provided me with plenty of material time and again for good briefs on work that otherwise I would have to do in original research.

Thank you.

CHAIRMAN MORRISSETT: Thank you, Mr. McDowell. There is a great amount of food for thought in Mr. Nelson's paper and in Mr. McDowell's fine discussion.

Is there anyone who would like to discuss this topic of the taxation of corporate holding companies further, before we proceed to the next paper?

CLARENCE L. TURNER (Pennsylvania): I was very much interested in the paper presented by Mr. Paul I was also interested in the paper of Mr. Nelson. Mr. Paul, at least, did not defend the personal holding companies or give them very much of a place. We have heard from Mr. Nelson and also Mr. McDowell on the purpose of corporate holding companies. I would like to point out that the so-called corporate holding companies also in certain cases fall in the same classification as the personal holding companies. The illustration of the Standard Oil is that there are a great number of corporations all doing business in corporate form owned by a large number of stockholders. We have in our office cases where one family has not only one business but several businesses that must be done by separate corporations, for the very same reason that the Standard Oil must do their business by separate corporations. But due to the fact that they are owned by one family, after you take in all the various relations, as defined in the act, they become classified as a personal holding company. Those companies have just as much of a service to perform in the economic structure as do holding companies similar to the one Mr. McDowell has described. Certain of these companies must be financed, and there are inter-company transactions which must be entered into between each of the companies which are necessary to their existence, and certain of such companies must temporarily retain their surplus, because they can't do both. But under the revenue acts of 1936, 1937, and 1938 they must pay it out, in order to avoid the tax.

The critics of these holding companies say that is the proper thing to do, they can pay it out and they can put it back into the company for capital purposes. But that cannot be done in a majority of the cases that are such as I am undertaking to illustrate.

When it comes to a personal holding company that is nothing more than an incorporated pocketbook, that is an entirely different matter. They are the kind of companies that the tax commissions are attempting to catch, in order to prohibit the avoidance of tax.

But as I see it, and as Mr. McDowell summed it up, such policy is punitive taxation, and as a result they are not only getting the guilty who are comparatively few in number, but also getting the legitimate people, corporations who are doing their business in a legitimate manner and really have a proper function to perform. The only answer, as I see it, is the restoration of consolidated returns. Then you will prohibit the taxation on profits that are fictitious, that can be avoided by inter-company transactions. I second not only what Mr. McDowell has said but what others have said in these sessions, that this association should stress to the government legislatures and those who are interested in taxation, that it is time to stop levying taxes for punitive purposes and confine it entirely to revenue purposes.

CHAIRMAN MORRISSETT: Does anyone else desire to discuss this subject of the taxation of corporate holding companies? If not, we may proceed to the next topic, which is somewhat related to what has gone before, "The Taxation of Intercorporate Dividends." We are privileged to have with us Mr. Robert N. Miller, attorney-at-law, Washington, D. C., who will now speak.

Mr. Miller!

ROBERT N. MILLER (District of Columbia): The papers we have heard set a terribly high mark for me in my attempt to deal with the subject that has been assigned to me by the very ingenious gentleman who sets up this program, devilishly ingenious, it seems to me, when I realize that my subject is what the chairman said, the taxation of intercorporate dividends.

THE TAXATION OF INTERCORPORATE DIVIDENDS

ROBERT N. MILLER
Attorney-at-Law, Washington, D. C.

I

To make definite the problem which I am to discuss, let us suppose that an individual owns some stock in corporation A, which in turn owns some stock in corporation B; corporation B earns profits, some of which are distributed to corporation A, which in turn distributes to the individual a part of what has been so received. The question of policy to be here discussed concerns the tax on corporation A. What policy is best for the government revenues, in respect of taxing *corporations* on dividends received?

Clearly this problem needs to be considered in relation to the structure and the whole plan of our income tax laws. There is time now for comment on only a few aspects of the general problem.

You will note that I am discussing a broader question than the one which would be involved if corporation A owned so much of the

stock of corporation B that the two corporations would be "affiliated" within the familiar tax definition of that word.

Until 1935 it was the policy of the federal government not to tax corporations on dividends received from other corporations; that is, in the situation supposed, corporation A would pay no tax on distributions to it.

This policy was based on a realization that the earning process here occurred only once—through the operations of corporation B—and on the principle that, so far as possible, a government does well to impose its whole tax at one time—immediately after the income is earned and against the taxpayer that earned it.

The policy of imposing the surtax on *individual* recipients of a dividend—proprietors whose enterprise has already been taxed once on its income—was recognized as conflicting with the just-stated principle of taking only one bite at each cherry, but was thought to be justified by the nature of a surtax—a tax imposed only on those persons whose substantial incomes indicated that they could bear an especial tax burden.[1]

In 1935, on the recommendation of the treasury, congress provided that corporation must treat ten per cent of their dividend receipts as income. In 1936 that percentage was increased to fifteen. Various changes made in 1938 have the effect of increasing the amount of tax on dividends received by corporations, including a change in pursuance of which the percentage taxed may exceed fifteen per cent in certain situations.

In seeking to discover whether or not this quite evident trend toward heavier taxation of dividends received by corporations is good for the government, it is interesting to note at this point what course is pursued in Great Britain, because that country has had much longer experience with income taxation than we have, and has been considered successful in its income tax policies. The practice there, with respect to dividends received by corporations, is not to tax them. In fact, in spite of a corporate tax rate of 27½ per cent in England, the total tax burden in that country per pound of corporate earnings, from the time they are earned until after they have been completely distributed to individual stockholders, is much less severe than the federal tax burden in the United States, whether the individuals are in the high or the low income tax brackets. If we take into account the additional tax burdens in this country from state taxation, the divergence is even more apparent. In England the individual is required to include in his taxable income the gross amount of dividends received, but is permitted to credit against his tax the 27½ per cent tax paid by the corporation.

[1] Note, however, that in the revenue act of 1936 and subsequent acts, dividends were made subject, when received by individuals, not merely to surtax but also to normal tax.

In the final analysis, little or no double taxation on corporate earnings occurs there. Here double taxation abounds; the intercompany dividend tax means multiple taxation.

I submit that the English tax policy is wiser than ours.

II

In 1935, when the treasury recommended that ten per cent of the dividend income of a corporation be included in its taxable income, the testimony of the treasury representative indicated that the probable effect of such a tax would be to implement the graduated corporation tax, and to prevent some corporations from escaping tax by intercompany transfers. But taking his testimony as a whole one gets the impression that the primary purpose of the provision was not to get revenue but to force simplification of corporate structures. This was in line with the position taken by influential advisers of the administration at the time. Among other remarks made by the treasury representative in presenting this recommendation to the senate finance committee were the following:

> "Intercorporate dividends are largely unnecessary transfers brought about and multiplied by complex corporate structures. There are many examples of these complicated corporate structures in the public utility field, but the same thing runs throughout the entire field of industry.
>
> "Up until last year the federal government had done little or nothing to discourage such needless complexities. Last year a definite step was taken in this direction by the abolition of consolidated returns. The partial elimination of the exemption allowed intercorporate dividends would be a further step in this direction and would have the effect of discouraging the multiplication of intermediate holding companies and of encouraging the creation and maintenance of straightforward capital structures that can be understood by the average investor and public official."

Was the treasury right or wrong when it thus took the position that intercorporate dividends were largely unnecessary transfers? If it was wrong—that is, if intercorporate dividends and the corporate situations from which they arise are in the ordinary case necessary to the welfare of the businesses in which they occur—then it is important to make serious re-examination of legislation enacted on the opposite assumption.

My own view, which I submit for criticism in the light of your experience, is that the treasury representative was wrong in that assumption, and that the federal government acted against the interests of its revenue system when it began to tax corporations on dividends received. My feeling is that nothing further ought to be done in that direction. On the contrary, the public interest would

be best served by undoing as early as possible what has been done in the 1935 act and subsequent acts.

My first reason for the conviction that this is a bad tax from the government's point of view has been suggested above: That there has been only one earning of income—by corporation B. The government should try to tax that income once for all, promptly after it has been earned, at as high a tax rate as is necessary—this tax to be payable by the corporation that earned the income. The distribution by corporation B is merely a passing on of profits earned by corporation B to one of the proprietors, corporation A. The stockholder has no right to receive them except as profits earned by corporation B. They are in these respects to be sharply distinguished from money received from a corporation by an employe for services rendered. This is an arm's-length transaction, not a mere passing on of profits, as such, to a proprietor; the employe has earned his pay even if the corporation earns no profit. So, also, interest received by one who lends to a corporation is true income, in that the bargain between lender and borrower involves a binding obligation that interest shall be paid, profits or no profits, as a consideration for the loan.

You will notice that the question we are considering has nothing to do with the powers of congress under the constitution. We are not here concerned with the meaning of the word "income" in the constitution, or with questions as to what can be done under the taxing power, such as those which arose in the Child Labor Tax case, the Firearms Tax case, and other cases in the supreme court. All that we are trying to do is to solve the practical question as to what kind of tax law would be best for the government. If we had no constitution and no supreme court, this question would still be important.

My second reason, and a more fundamental one, is the conviction, based on my own experience, that a government's need of revenue is a vital and primary need, that the income tax is a peculiarly useful and almost indispensable agency in supplying that need, and that it is an agency which functions acceptably only when devoted to the single purpose of getting revenue. In other words, a government cannot with safety to itself allow non-revenue purposes to be dominant in the provisions of any part of its income tax law.

The tax on intercompany dividends, I believe, is undesirable from the government's standpoint not merely as violating that principle, but as violating it in a way which is particularly likely to cause injury to the revenue. Such injury, in this instance, is likely to be serious, and a really substantial increase in severity would in my judgment involve too serious a risk of throwing the business of this country into grave disarrangement, and of producing a deflationary effect on the stock market due to large-scale selling of stocks.

It is true enough that there are many important regulatory functions which the government must exercise, and that for the attainment of some regulatory aims the income tax might be a splendidly useful instrument. Nevertheless, in my view the government is forced, by its own revenue necessities, to rely in that connection on other sanctions than the income tax. One test of the ability and resourcefulness of governmental planners is whether they are determined and ingenious in finding other ways of exerting pressure for regulatory purposes, or whether they feel helpless if they cannot use the taxation method.

To use a homely illustration, there are household situations in which my toothbrush could be used on other things than teeth. It could be used for cleaning shoes, for instance, but such a use would leave it in no proper shape to put into my mouth, and the sensible thing is to use something else for cleaning shoes. Anyone who says this to an enthusiast on the subject of cleaning shoes will be criticised as being out of sympathy with that worthy purpose, but no one who is able to see the real point would make such an accusation.

What I have said does not by any means reflect a view that the non-revenue effects of revenue measures should be ignored. On the contrary, every possible effect of a proposed revenue law ought to be fully explored; as between various possible revenue measures, that one should be chosen which is best in its non-revenue repercussions. But the conviction that such incidental effects of a revenue law must be carefully kept in mind does not conflict with the conviction that the purpose of an income tax law had best be the getting of revenue and that non-revenue results must be incidental and not primary.

I do not assert that every phase of the revenue powers must be exclusively devoted to revenue-getting, but confine my statement to a single type of tax—the income tax. This tax has its peculiar excellences and peculiar difficulties, which argue very strongly against using it for bifurcated purposes — partly for revenue, partly for regulation.

If I were approaching this subject from a theoretical or a constitutional point of view, rather than from the practical point of view of a government which needs a continuous flow of revenue, I might emphasize the theoretical inaptness of using a revenue power for a non-revenue purpose, but that has no real bearing on the problem which is before us here,—the problem of deciding what kind of income tax law will really work best. The excise taxes on the sale of narcotics and firearms are examples of the use of revenue powers for non-revenue purposes, but since experience indicates that such taxes are administratively separable from the rest of the revenue system, and do not in any noticeable degree interfere with major revenue sources, such as the income tax, no objection need be taken

to them in a practical discussion. For the same reason we are not here much concerned with the traditional dispute in which the proponents of a tariff for revenue only have made such poor headway. Our revenue system does not rely very heavily on tariffs.

Let us pause long enough to realize how far a government's need for revenue towers above its need for regulation. It is not too much to say that the very life of a government depends on its revenues, just as the life of a diver depends on the air which is pumped down to him from the surface. The diver would be right in demanding that the air pump and the air tubes be devoted exclusively to that single purpose, notwithstanding the many other worthy uses which could easily be suggested.

Wherever the attempt has been made to use revenue machinery and revenue powers for non-taxation purposes, there has appeared a tendency to overemphasize the relative importance of the non-revenue purposes to be served. Thus, those who have advocated taxing corporations on dividends as a means of forcing the simplification of corporate structures have, it appears to me, failed to give full effect to the fact that by far the greater number of intercorporate relationships are dictated purely by business necessities. To impose punitive taxes on a relatively small class of objectionable corporate groups does some good, but the consequent harm is greater than the good, because of the injury to legitimate business and to the whole revenue system. The government revenue from income taxes immediately falls if business is injured. The important and wholly proper service rendered by subsidiaries is obvious, and has been frequently recognized by well-informed writers, such, for instance, as Berle and Means. Under this law the legitimate or necessary use of subsidiaries involves as heavy a tax penalty as must be borne when the use is not legitimate, so that a large class of the innocent users are made to suffer because a small class needs regulating. A business which is free to conduct its branches either as separate corporations or as mere unincorporated divisions has a hard enough time making profits. Its chances of success are cut down when its freedom to choose is taken away by a tax law intended to put a penalty on one of the possible choices. It is the old principle that a man with one hand tied behind him cannot get along quite as well as if he were free. The sensitiveness of the income tax to business conditions is vividly illustrated when we realize that the total income tax collections for 1930 were over \$2,400,000,000 and for 1933, with greatly increased tax rates, less than \$747,000,000—a difference between these two years of over a billion and a half dollars. In other words, if the government is going to get a large revenue from income taxes, there must be large profits to tax.

As emphasized in the recent report of the American Bar Association Committee on federal taxation, it gets harder and harder to

construe an income tax law, in proportion as the purposes of the law become more confused—especially when inconsistent purposes are found in the same law:

> "*Revenue Measures for Non-Revenue Purposes.* — Taxing provisions which have a double purpose—that of getting revenue and that of inducing certain lines of conduct—necessarily involve more complexity, both in construction and in administration. Anything that is written with a double purpose is more difficult to express, and harder to understand. Furthermore, the courts have greater difficulty in filling interstices in a double-purpose law, because it is difficult for a court to preserve proper balance between the revenue purpose and the non-revenue purpose. In the administrative field, it is usually possible to preserve a closer relationship between taxpayer and government when the law is purely a revenue measure than when the treasury is placed in the position of being a director of conduct as well as a mere collector of needed government revenues. There is also sometimes a conflict between the two purposes, because the more obediently the taxpayer pursues the desired course of conduct, the less revenue the government gets. An extreme example was the (unconstitutional) *special* income tax on child labor; attainment of the real object, that of eliminating child labor, tended to cut down the tax receipts, under that law, to nothing."

In another part of the same report that committee points out that the government is the worst sufferer when revenue laws are hard to construe. The report counsels avoidance of "provisions which are difficult to understand, encouraging non-compliance by making it difficult for the authorities to distinguish between intentional and merely ignorant non-compliance."

Mislabelling anything is always likely to be deceptive and dangerous, whether in the field of foodstuffs or medicine or commodities or legislation. To disguise regulation as taxation is bound to cause confusion and difficulty, in a field where they are peculiarly dangerous to the state.

It should further be noticed that, even if it be assumed that in certain situations the effectiveness of the income tax as a regulating agency justifies its use, we are not dealing with such a situation here. The regulating effect of this tax is too weak and too uncertain to counterbalance its disadvantageous effects on the revenue.

If we could imagine a wholly selfish government, with no interest in being fair and with a conviction that only the simplest corporate structures should be tolerated, I am suggesting that even such a government might find it profitable, on the most cold-blooded basis, not to impose this tax as it is now imposed.

III

I mentioned a short time ago that one of the arguments submitted to congress in support of the treasury's recommendation was that graduated or "progressive" income tax rates for corporate income are advisable, that such graduated rates can be defeated by splitting up the income of a business among a number of corporations, and that such avoidance would be discouraged by taxing intercompany dividends. This appears to me an additional instance of the rule that those who want to use revenue measures for non-revenue purposes fail in their sense of proportion. I am impressed with the truth of the following comment on this argument, taken from the book, "Facing the Tax Problem," published by the Twentieth Century Fund, Inc. (p. 179):

> "The 1936 change in dividend deductions was made ostensibly to prevent avoidance of the progressive rates of the corporation income tax laws of 1935 and 1936 by discouraging division of the income of a business among several subsidiary corporate units. However, substantial avoidance would be unpractical for a large corporation since its business would have to be divided among numerous small subsidiaries. Furthermore, such avoidance could be prevented by taxing subsidiaries at the highest rate of taxation applicable to the whole affiliated group."

Furthermore, the idea of graduated rates in levying the income tax on corporations is one of doubtful usefulness and hence not worth much sacrifice in attempting to protect it.

IV

The treasury, when it advocated this tax in 1935, estimated that it would produce annually something under forty million dollars. Whether actual collections were less or greater, it remains true that the propriety and usefulness of any tax provision depend upon many elements, of which the amount directly produced is only one. A provision that produces fifty million might do many times that amount of damage to the entire revenue structure by impairing the admirable tax-paying habit of the American public, or might be undesirable in comparison with some other type of taxation which would have produced more money with less injury to the taxpayer and less disturbance of the revenue system as a whole.

No one doubts that it is often easier, in securing the enactment of tax legislation, to impose a new tax than to increase the rate of an existing tax. Legislators and their constituents, if they have had no sufficient opportunity to realize the results of the proposed tax, are not prepared to oppose the views of those who advocate it. For that reason less opposition was to be expected when this tax

was proposed than if the government had suggested increasing the tax rate on operating profits earned by corporations. But although it may be convenient to take the politically easier path, such a choice is not infrequently against the interest of the United States. The consequences do not always come immediately, but it is the government, in the long run, that has to bear the burden of all opportunist amendments to revenue laws.

V

There are political questions connected with this subject. Have we political leaders able enough to bring about the amelioration of the present tax on dividends received by corporations, assuming that the public interest would be well served by such ameliorations? Will politicians be able to resist the impulse to advocate increasing the burden of such taxes, in view of the general belief among politicians that such advocacy is a useful means of getting votes? I cannot answer these questions, but I am more optimistic as to the quality of our future leadership than many people are.

Before I close it is well to observe that the enactment of general provisions permitting an affiliated group of corporations to file a consolidated return—provisions such as those in effect until 1934—and the consequent elimination of intercompany transactions in such returns, would for practical purposes solve the taxation problem discussed here. I happen to be one of those who believe that the government's interests were well served by the consolidated returns provisions and were injured by their repeal. I am convinced that the government's interest is best served by a policy of imposing the income tax on each business unit as such, whether its branches are incorporated or not; I would even favor making consolidated returns compulsory.

In turning the subject back to you for discussion, let me say that every good citizen should be conscious of the reforms which are needed in this country, and should try to help in devising ways by which these difficult aims may be accomplished. But every citizen, also, must realize that reforms cannot go forward except in a country whose revenues are on a sound basis. Ways and means for promoting reform must be discovered which do not destroy or impair the revenue system. Even if a builder has difficulty in finding materials to complete the roof of a house, he does not, if he is sensible, tear out the foundation of the house to get roof materials.

The revenue system is fundamental in our government, as it is in all governments, and the income tax is at present an indispensable structural element in that system. We must make our plans so as to succeed both in preserving the foundation and completing the superstructure, without conflict between these two important purposes.

CHAIRMAN MORRISSETT: Thank you very much, Mr. Miller.

We now proceed to a discussion of this very interesting paper and we have with us Mr. A. R. Kaiser, tax agent, Sears, Roebuck & Company, Chicago, who will now be recognized.

A. R. KAISER (Illinois): Gentlemen, I have read Mr. Miller's paper. He hasn't given it all to you. I commend it to you. You ought to take it and read it. He has left out of it a lot which is very valuable.

Discussion of THE TAXATION OF INTERCORPORATE DIVIDENDS

A. R. KAISER

Tax Agent, Sears, Roebuck & Co., Chicago

Certainly the subject which has been assigned to Mr. Miller and myself is one in which we cannot practice plagiarism. I can find very little written on the subject. Mr. Miller, in his usual manner, has comprehensively covered the subject before us, namely, the tax on dividends of domestic corporations. His homely illustrations are highly emphatic of the principles he outlines. I find myself in complete agreement with his conclusions. Therefore, I may be out of place in attempting to lead the discussion on the subject. Perhaps some one else can take issue with him, after I have finished. I find myself unable to do so. The thoroughness with which he has covered the subject leaves for me little more than to emphasize some of the principles he has outlined, that might be enlarged upon.

I wish to consider the problem from the viewpoint of the business man, who is forced to conform his business, in accordance with the changing, and to my way of thinking, an illogical and economically unsound trend in federal taxation, and bear the burdens imposed by such taxation.

Permit me first to briefly summarize, for purposes of emphasis, some of the important criticisms Mr. Miller has made, as follows:

(1) The tax on income should be levied *only once*, instead of two or more times. I would like to add that the laws of the land do not punish a criminal twice for the same crime. Should our government tax more than once its citizens, who, because they are successful, perform an essential function in our industrial and social system, and keep the life-blood of the government flowing?

(2) The tax should be levied *only approximately at the time* it is earned, and not at some remote period.

(3) The tax should be levied *at the source* where earned.

(4) The income tax fills a *primary and vital* need for the government, and therefore it should not be hampered or impeded by non-essential regulatory measures which tend to destroy its efficiency.

(5) There are other considerations in judging the value of the revenue laws, than its ability to produce *immediate* income. The longer view should be considered. What will be the future effect of the revenue?

(6) The adoption of *consolidated return* provisions such as existed prior to 1934.

If intercorporate dividends were excluded from tax under the act, few if any large corporations would or could create subsidiaries in order to save the small amount of tax that would result from a graduated tax in the brackets of income below $25,000. The reduction in tax on $25,000 of income would amount to only about $700. In order for a corporation with an income of $1,000,000 to reap the *full* benefit of the lower tax, it would have to be broken up into 40 corporations with incomes of exactly $25,000 each. If it did so, it would save about $28,000 in income tax. What would the legal costs of incorporating 40 new corporations amount to? Then also, it is evidently impossible to break up a large single plant into a multiple number of corporations.

I

I want to touch briefly upon the history of consolidated return provisions, because the principles involved therein are closely related to the principles of taxing intercorporate dividends. The need for consolidated returns was early recognized by the treasury department in determining the high excess profits tax rates under the 1917 act. It realized the inequities and difficulties of trying to tax each division of the economic unit separately. The regulations provided for consolidated returns although they were not mentioned in the act itself. From this time until 1934, consolidated returns were required or permitted. In 1934, the consolidation provisions were eliminated except for railroad corporations. Immediately difficulties were encountered. Losses of one subsidiary, which was an integral part of the business, were not allowed to be deducted against profits of another subsidiary which was also an integral part of the same economic business unit. This resulted in taxing more income than was realized by the economic business unit. Or, to put it in another way, it resulted in taxing some of the income twice. The 1935 and 1936 acts aggravated the situation by introducing the new principle of graduated income tax, and the tax on intercorporate dividends. This portion of the law did not receive its share of consideration and criticism at that time, as it was overshadowed by grave considerations of the surtax on undistributed profits, the principles of which soon fell into disrepute. When the principle of taxation was being discussed in connection with the 1935 act, it was pointed out that this kind of tax would raise $40,000,000 in taxes. A very important question is: "How much revenue will it eventually dry up at the source?"

II

Let's look at the magnitude and the importance of this problem. A representative of the treasury department in speaking before the senate finance committee on the proposed revenue act of 1935, stated that the dividends that would be affected by this legislation had been estimated at $1,900,000,000 for 1935, and that the amounts in prior years that would have been so affected if the law had been in effect then were:

1931	$3,900,000,000
1932	2,100,000,000
1933	1,650,000,000
1934	1,750,000,000

In its report on the proposed 1934 bill, the house committee pointed out that for the years 1928 to 1931, inclusive, the percentage of gross income reported on consolidated returns amounted to approximately 45% of the total gross income reported by all corporations. It is, therefore, evident that this problem is important because of the number of corporations, and the large proportion of corporate income involved.

III

In his very intelligent analysis of the subject, Mr. Miller confined himself largely to the dividends paid by non-affiliates. The problem is of importance, as it relates to dividends paid by subsidiaries to the owning parent corporation. When the revenue act of 1934 was being considered by the subcommittee of the committee on ways and means, the present secretary of the treasury, then acting secretary, opposed the abolition of the consolidated returns provisions, by stating that it "might well be a backward step." But the treasury department has since taken the position that the elimination of consolidated returns was the first necessary step in the much needed simplification of the complex corporate structure; and that the tax on intercorporate dividends was the second step. It cited as glaring examples, certain nefarious practices of a few highly integrated businesses. Should the government infer that since certain members of industry *may* be bad, *that all* are bad? Should the masses be punished because of the sins of a few? Evidently the government seeks to eliminate all intercompany holdings. Why? Do wholly owned subsidiaries, in general, present any serious problem to revenue agents or investors, as the government infers? We are compelled to disagree. Does the government infer that wholly owned subsidiaries are created by corporations for some unreasonable or unethical reasons? Complex problems with which business is confronted make necessary the formation of legal entities that are best adapted to the complex pattern of state and federal laws.

Sometimes corporations are formed in particular states because some peculiarity in the state law makes it necessary to establish subsidiaries, in order to compete with other business in the state. The necessity for subsidiaries is evidenced by the fact that approximately half of all corporations, in volume of income, have found it necessary to have one or more subsidiaries. Surely they have not formed separate corporations without good economic and business reasons therefor.

Let's consider the confusion that arises under this kind of revenue acts. A considerable number of subsidiary corporations have been dissolved. Many of them probably had historical reasons for formation, which no longer exist. To such, the legislation being discussed is not important. The reasons for the existence of many subsidiaries still exist. If these subsidiaries were dissolved, the reasons which prompted their incorporation would then create inconvenience, difficulties, and expense. Some subsidiaries were formed for such important reasons that they will be retained regardless of the present tax. Consequently this new tax will mean adding to the already existing burdens.

(a) This in turn will prompt some taxpayers to avoid this added tax through the medium of adjusting prices of intercorporate sales and charges in its intercorporate dealings, which the treasury department has indicated they are practically powerless to prevent.

(b) The results of intercorporate shifting of income might be that in order to stamp out these practices, and force dissolution of subsidiaries, the government might increase the rates of tax on income of subsidiary companies. Other regulatory laws might be enacted. The statute would soon become purely a regulatory provision. Should the object of revenue laws be to regulate, or should it be to raise revenue?

(c) Few corporations pay out all their net earnings in dividends, even under the present tax on undistributed profits. Such parent corporations can avoid the penalty of tax on intercorporate dividends by allowing the subsidiaries to retain their income. They would pay a surtax on undistributed profits of approximately 2½%. The parent company would have to pay this rate of tax anyway on that portion of its income that it did not pay out as dividends. Thus the tax of 2½% on intercorporate dividends can be circumvented, by the subsidiary retaining its earnings.

(d) To close this loophole the government might again increase rates. Thus the revenue law might become almost purely a regulatory law and the road for business become more and more difficult.

IV

We now come to consideration of intercorporate dividends in the case of only a small or partial ownership of the stock of another corporation. Here again, it is the ostensible object of the government to eliminate intercorporate holdings. Intercorporate holdings will not be disposed of because of a tax of 2½% on the intercorporate dividends, if the investment is profitable. Therefore, in order to accomplish its stated purpose of forcing the discontinuance of intercorporate holdings, the government will be forced to increase the rates. It clearly follows that the trend of this kind of legislation leads directly to punitive measures, and regulation. Revenue would again be secondary. Note again that confusion arises. In order for corporations to eliminate their partial holdings in other companies, they must either purchase the balance of the capital stock and liquidate the subsidiary; or they are faced with the alternative of dumping the stock on the market. The first alternative is usually impractical, if not impossible. The second alternative will force the stock held by corporations into the open market. The price will drop perceptibly because of the forced sale. Then we have reached the situation where a tax has in effect become a capital levy on those corporations which have partial holdings in others.

V

If this philosophy of taxation continues, the picture is not bright for the corporate taxpayer that owns stock in other corporations. This regulatory provision, if carried out according to its objectives, must ultimately produce little or no income, and at the same time would further complicate an already too complicated statute. The far-reaching effect of legislation of this type is to put one more obstacle in the path of business incentive, and capacity to make profits. When profits are reduced, the government revenue must decrease also. It appears to be pointing clearly in the direction of "killing the goose that lays the golden egg." As the proportion of total income extracted by the government becomes larger, the less there is left for investment in industry and for use in the production of commodities. This makes commodities scarcer and costlier. The direct result is a reduction in the standard of living of the masses, instead of raising that of the underprivileged one-third.

Mr. Chairman, I now turn the subject back to you for further discussion.

Chairman Morrissett: Thank you very much, Mr. Kaiser.

Now we have plenty of time for a full discussion on this subject. It is eleven thirty-five. Does anyone wish to be heard now on the taxation of intercorporate dividends?

LEO MATTERSDORF (New York): I have a resolution to introduce and I have been told to introduce it after the speakers got through. If no one wants to discuss this subject for a moment I would like to read this resolution. It is a short one. May I do so?

CHAIRMAN MORRISSETT: The resolution may be read and introduced.

MR. MATTERSDORF: This resolution is being introduced at the direction of the committee on allocation of income.

> "WHEREAS, the committee on allocation of income of the National Tax Association has presented a report to this conference disapproving of the growing practice of legislatures in the several states of granting permission to jurisdictions smaller than states to levy taxes based on gross income, gross receipts, or net income, and
>
> "WHEREAS, it appears to this conference that any growth of this practice will result in the defeat of any attempt at uniformity in allocating income and in this respect make worse an already bad situation, now, therefore, be it
>
> "RESOLVED, that it is the sense of this conference that no governmental unit exercising the power to tax within a smaller governmental unit than the state, excluding from the scope hereof the District of Columbia, be authorized to impose taxes on, or measured by, gross receipts, gross income, or net income."

CHAIRMAN MORRISSETT: Under the rules, the resolution will be received and referred to the committee. It cannot be discussed at this stage.

Now I shall turn the gavel back to our president, with expression of appreciation to him for the honor which he conferred upon me, and appreciation to you for your very courteous consideration.

CHAIRMAN LELAND: Well, Charlie is back again with a few matters of business to announce. The rules of the association provide that the nominations committee shall consist of all of the past presidents in attendance at the conference, together with three others selected by the president. I am therefore making my selection and designating the nominating committee as follows: chairman, Professor Harley Lutz; additional members of the committee, Henry F. Long, Philip Zoercher, Clarence Smith, Franklin S. Edmonds, Robert M. Haig, and any other past presidents who put in an appearance at the conference, together with Carl S. Lamb, Royal B. Cushing, and Charles V. Galloway. Those gentlemen will constitute the nominating committee.

The rules adopted by the conference provide for a resolutions committee to pass upon the resolutions presented on the floor and

to bring up such other resolutions as they care to have the conference consider. I have designated Henry F. Long as chairman of that committee, and to date only nine states have indicated their selections. If we do not receive any other names during the day, I will announce the complete roster of the resolutions committee at the morning session.

I want to call your attention to the luncheon that is to be held in the Michigan Room on research in reference to assessments. There have been several research projects conducted throughout the country with reference to the assessment of property, the characteristics of property subject to assessment, and one of the most interesting of those surveys has been conducted in Michigan. Mr. Albert Champney, director of taxation for Wayne County, Michigan, and Mr. Charles D. Rosa, director of administration of the Michigan Tax Commission, will tell us something about their work at the noon luncheon which will be in the Michigan Room.

May I urge all of you to remember the dinner this evening and the session at the Dearborn Inn, and to the extent that you have not yet purchased tickets, I hope you will do so.

I am also called upon to announce, for the benefit of those who cannot read, that the committee of the National Tax Association on federal taxation of corporations will meet today at twelve-fifteen in Parlor B.

Are there any other things to announce which I have forgotten? Are there any other matters to be called to the attention of the conference? Is there any further discussion of the excellent papers of this morning or the points raised by any of those who have participated in the discussions?

Then we will adjourn until twelve-fifteen when we can assemble in the Michigan Room and two-fifteen when the buses will leave for Greenfield Village, and until six-fifteen when we will have dinner in Dearborn.

(The meeting thereupon adjourned at eleven-forty o'clock.)

NINTH SESSION

LUNCHEON SESSION

WEDNESDAY, OCTOBER 26, 1938, 12:15 P. M.

JAMES W. MARTIN, presiding.

CHAIRMAN MARTIN: Will the conference come to order? Let us proceed in developing the very brief program that has been scheduled for this luncheon. The chairman's job will be simply to wield the big stick and not to make a speech because the length of time available to us is not great and the principal speakers and the persons who desire to discuss their papers will need all the time.

I therefore call on my friend, Mr. Albert E. Champney, who will discuss with you some of the problems that have arisen incident to the assessment survey in Wayne County, Michigan.

Mr. Champney!

ALBERT E. CHAMPNEY (Michigan): Mr. Chairman, Ladies and Gentlemen: Last January I persuaded Dr. Leland to address a meeting where the audience was not friendly to the subject matter that he was discussing. I hope that he is not trying to retaliate on me here.

WAYNE COUNTY ASSESSMENT SURVEY

ALBERT E. CHAMPNEY
Director, Bureau of Taxation,
Wayne County, Mich.

"Beginning at a nail driven in the crotch of a button-ball tree; thence on a line to the east 100 paces to the Jones farm; thence on a line to the north a stone's throw to Aunt Fanny's tract; thence to highway; thence to beginning."

This homely listing of local 19th-century landmarks and many other similar nostalgic descriptions of property embellished the tax rolls of the townships in Wayne County for many years. Obviously, tax liens could not be enforced against such indefinite descriptions.

The tax rolls in most districts in the county of Wayne in 1933 were nearly identical with the rolls prepared at the time of the adoption of the Michigan General Tax Law in 1893. They were bound books in which were written by hand the property descriptions inherited from previous guardians of the tax rolls, with only

such minor modifications annually as were required by individual complaints, and the weird mutations which resulted naturally from the clerical errors of successive supervisors.

Not only were the tax rolls replete with venerable descriptions, scribbled for the most part in books which one would expect to find in the laboratory of a Victorian-age apothecary's shop, but there were almost as many methods of listing property as there were townships—some alphabetically by the owners' names, others by school districts, others by sections, others by happenstance.

This condition resulted in the rejection during one three-year period alone of more than two million of dollars in taxes.

Therefore, the primary objectives of the Wayne County Assessment Survey, which began as a CWA project in December, 1933, were to ascertain a correct description for each parcel of property subject to taxation in the unincorporated areas of Wayne County, and to provide a uniform assessment record.

At that time, which was near the high-point of unemployment, there was a plentiful supply of trained engineers, draftsmen, clerks, and other persons required for this sort of undertaking. The application for personnel called for approximately a thousand trained persons. The peak payroll, however, never exceeded 540. Nevertheless, because of the ample supply of competent persons at that time, we were able to complete, during the short life of the CWA program, outline surveys of approximately ninety per cent of the government survey sections in the area involved, which covers about 433 square miles. I mention this fact particularly because it would be difficult under the present WPA program to secure a sufficient number of technically trained persons to conduct so extensive a land survey program in a short period of time.

The project was continued under the emergency relief program which followed the CWA, and is now being carried on under the Works Progress Administration. During the latter two programs the number of personnel paid by the federal government has ranged between 85 and 100.

As the work of the project has advanced toward the finished product stage, it has been necessary to increase the county contribution to make it possible to retain on a regular employment basis the requisite professionally trained technicians who would otherwise have been absorbed in private employment. This staff now numbers 15—consisting of one chief engineer, three civil engineers, four party chiefs, six draftsmen, and one chief clerk. The WPA staff consists of stenographers, clerks, typists, proofreaders, rodmen, chainmen, instrument men, and a few draftsmen.

To get a general picture of the complexity of the problem of developing a systematic survey of the area, it is necessary to consider the historical influences which affected the property boundaries here. During the occupation of this territory by the French

in the early 18th century, a great many land grants were made which consisted for the most part of long narrow strips of land extending backward from water courses.

During the British occupation of the territory from 1765 to 1796 these land grants were not disturbed.

The United States government subsequently accepted the rights granted in these French claims and permitted them to be recorded, which made them basic subdivisions of property in the area. Between 1808 and 1817 the United States Government Survey was made and all of the area not included in French land grants was placed under the section and township system.

One of the early tasks of the Assessment Record Project was to establish the relationship between the French private claims and the government survey. This work has been completed and the resulting map forms the skeleton into which are being fitted detailed property maps and plats.

I have stated that one of the primary objectives of the project was the correction of all descriptions of property for the assessment rolls of the several districts.

It was our opinion that if we were to establish a permanently effective record of descriptions of property for tax purposes, we must not merely patch existing tax roll descriptions by inspection and compilation. The problem resolved itself into the reconciliation of three distinct evidences of property boundaries, namely: existing assessment roll descriptions, deed records, and the actual physical boundaries.

We therefore adopted the procedure of transcribing the two written records of property to loose-leaf memorandum form so that they could be compared, plotted and, when possible, fitted into the outline surveys of geographical subdivisions. Wherever necessary to complete the reconciliation, actual land surveys were made. In this way we have been able to account for all property in the districts where the surveys have been completed.

For the proper recording and maintenance of these corrected descriptions, a card ledger system was installed showing the correct description, ownership, land and building value data, and assessments over a period of years. The cards were prepared in duplicate—one set being provided the assessing officer of each district and the master set remaining in the files of the bureau of taxation.

The property is listed in these files geographically, beginning with the first section of the township, numerically, and is the pattern for the listing of descriptions in all tax records, including assessment rolls, tax rolls, delinquent tax rolls, and tax bills. The master card record in the bureau of taxation serves as the control for all changes in tax records.

It was obvious that corrected descriptions would not long remain correct if left to be copied as before, hence it was determined that

they would be embossed on addressograph plates from which all subsequent tax records would be prepared. At the present time we have approximately 155,000 corrected descriptions placed upon addressograph plates.

From these plates we are printing, for the districts in which the survey has been completed, loose leaf assessment and tax rolls.

Next we set up a central installation of mechanical equipment for the spreading of taxes on these new rolls. In logical sequence we have also provided mechanical equipment for the spreading of tax bills to permit the pre-billing of taxes. This was not previously the practice, largely because it was not feasible to prepare the bills by hand.

We feel that one of the distinct advantages of this central installation of mechanical equipment for the preparation of tax records for local districts is that it provides an opportunity for the application of modern methods, which would be prohibited to the districts if each were required to purchase and operate a separate installation of the expensive equipment necessary.

Because of the vast number of properties and the complexity of many of the local descriptions, we have devised a coding system to facilitate the identification of property, to simplify collection records, and in anticipation of the ultimate establishment of a unit ledger tax record for the county.

Not only were the descriptions of property on the existing assessment rolls incorrect and incomplete but there were no accurate property maps in any of the districts. It therefore became a part of the program of the project to develop for each district a complete, detailed property map showing the proper relationships among the parcels. These maps are prepared on tracings from which any desired number of prints may be obtained. The scale used is 200 feet to the inch, and the quarter section of the government survey has been adopted as the map page unit. These maps are grouped in books by townships, a full geographical township consisting of 144 pages. Copies are provided to both assessing and tax-collecting officers.

Using these property maps as the basis we are also developing for each district land value maps in smaller scale—500 feet to the inch—omitting property line details, but recording all information pertinent to the development and determination of unit land values. The section rather than the quarter section is employed as the page unit in these maps.

All these things would soon become obsolete and useless unless provisions were made for their current maintenance, so we instituted a routine procedure which is intended to assure that all changes occurring in the ownership or boundaries of property are made in all the necessary records: the card ledger, addressograph plates,

maps, and assessment and tax rolls. Through an arrangement with the assessing and collecting officers changes of this nature are currently reported. In addition, we receive daily a copy of every conveyance recorded with the register of deeds.

Changes in maps are accumulated and made on the tracing each year prior to the assessment date, so each assessing officer at the time he makes his assessment may be equipped with an up-to-date property map of his district.

As the maps and records are completed for any township or city, the bureau of taxation provides the assessing officer with a complete real property inventory which consists of building measurements and all other building information pertinent to the valuation of buildings, and also land value data from which may be developed unit land values.

Up to the present time we have completed our program in nine townships and one city. Before the assessment period in April of 1939, our schedule calls for the completion of three more townships and one more city. It is our hope that within two or three years there will have been established for the entire county of Wayne, containing one million descriptions of property, a modern and uniform system for the making and recording of property assessments and for the levying and collection of taxes.

I wish to emphasize that whatever progress has been made by the Wayne County Assessment Survey has been possible largely through the whole-hearted cooperation of local officials, particularly township supervisors in whose jurisdictions we have been working. We have also benefited by the willing aid and assistance of all county departments concerned with tax and property records.

We began this discussion at a nail driven in the crotch of a button-ball tree. That button-ball tree is gone long since, and I sincerely hope that its passage foreshadows the departure from local government of the now outmoded methods of assessment which its homely simplicity as a landmark epitomized.

Chairman Martin: Since Mr. Champney has so eloquently emphasized this tree, lest Professor Leland and Professor Plehn give Kentucky away, I will admit right at the beginning that the only difference between our descriptions and the Michigan description is that in many instances we never get back to the starting point.

The next speaker on this program is a man who doesn't need any introduction to this audience, but who is known to all tax administrators and tax officials everywhere as a member of the Wisconsin Tax Commission for many years and now a director of administration with the Michigan Tax Commission. He will discuss, by way of comparison with the situation which has been described,

some of the work that was accomplished in Wisconsin prior to his departure from that state.

I take great pleasure in introducing Judge Rosa, of Michigan.

CHARLES D. ROSA (Michigan): Mr. Chairman, and Ladies and Gentlemen: I am sorry that I have been so busy in recent weeks finishing up a re-assessment for my friend, Mr. Champney, in the town of Ecorse, in Wayne County, that I haven't had the time to write down what I have to say.

I am always in favor of a written speech. I learned this lesson, not directly, as far as I was concerned, but in a very graphic way in 1913. I was a member of the legislative delegation of Wisconsin which chartered the steamer Alabama and went to Put-in Bay to help celebrate the Perry Centennial.

While there we went over to Cedar Point to a banquet that I understand cost the state $14 a plate. It was a nice banquet. The toastmaster was Mr. William H. Taft. There were seven governors on the program.

Well, I don't suppose by friend Martin had anything to do with it, but the governor from Kentucky gummed up the program. I will let him tell you what the reasons were. But about three o'clock in the morning Mr. Taft got up and sort of elbowed the governor of Kentucky out of the position that he had occupied for forty minutes and took a seat, and as he did so, Governor Ferris, of Michigan, jumped up and rushed to the fore in order to get the place before the governor of Kentucky could come back.

As he did so, he opened his coat and pulled out a manuscript. From where I sat I could see the vast audience of 1500 in that dining room go down in their chairs about three or four inches further. He said, "Now, don't be alarmed. I have written down what I have to say for two reasons, first, so that I can get through, and second, so that I will know when I am through."

Then he proceeded to read one of the best ten-minute papers I have ever listened to. Since then I have made a practice of writing down what I have to say, and I am very sorry indeed that I haven't a written paper today.

I was to say something about what we did under CWA, FERA, PWA and WPA, and so forth, in Wisconsin, along the lines that have already been suggested by Mr. Champney. You all remember the bad days of November 1933 when the CWA project was launched. We had a set-up in Wisconsin at the time, and still have it, that fitted in very well with the picture. The general property tax set-up consisted of supervisors of assessment in various districts with deputies and an office force. It was a very fine supervisory body. We got a project. I think we got it in about 36 hours, a little shorter time than it takes now. We had, prior to that time, through a field book, and a compelled classification of property

which was put into effect by the Wisconsin Tax Commission in 1925, covered pretty well the rural few.

We had designed a data or inventory card for the rural property of the state and made some headway before the depression stopped us. Then was our chance, we thought, so we got this project, turned the printing presses to putting out these cards, and before the CWA was terminated in April, we had spent a million dollars of the federal government's money, and had carded probably about 95 per cent of the cities and villages of the state, more than 75 per cent of all the different descriptions.

We went on and pushed that to completion under FERA, and later under the WPA, and PWA. As Mr. Champney has already mentioned, at that time it was possible in our cities to get very high-class and well-trained help for this work. When we finished the job we had two cards for every piece of property in the state, as far as we went, and it is practically completed. One of those cards was in the assessor's office of every municipality, village or city in the state. The other corresponding card was in the office of the supervisor of assessments of that district. Repeated tests showed us that our men could go into a village or city and after checking the cards for accuracy, by spot checking here and there, could appraise between four and five times the amount of property in a given length of time as they could when they had to do the details themselves before, indicating what a tremendous advantage the data or inventory card of a parcel of property is or can be to the assessing officer of a municipality.

We also went into the proposition of correcting descriptions. They say it is an ill wind that blows nobody any good, and so the depression did things to county boards in Wisconsin that we had found it impossible to do for fifteen years. In Wisconsin the set-up is different than in Michigan, and probably different from that in many states. Delinquent taxes are returned to the county, and the county sells the property and holds the bag. They found that the taxes on many descriptions of property that had been paid for generations weren't paid when the depression came. Then they discovered that there were a number of pieces of property that were extremely defective, that they couldn't sell, that had to be charged back to the locality.

So the loss of taxes through that sort of thing made the county board of supervisors very mellow indeed toward our proposition to get some projects, make maps, and correct the descriptions and really institute an up-to-date system of handling those matters. So county after county went along with us and we not only corrected the descriptions but in the end the county established a personnel with sufficient help to keep the records up to date in some such way as Mr. Champney has mentioned.

We also installed machines. I was telling Mr. Champney before lunch that when the average income tax law went into effect in Wisconsin, that Mr. Leenhouts, our assessor of incomes in the city of Milwaukee, estimated that it would take $40,000 more for clerical help in his office alone. With the advent of Moon-Hopkins machines and other machines, we got a contract out of a company to do the computing on our income tax returns in the city of Milwaukee at a cent apiece. These computations were made on the 200,000 income tax returns at a cost of $2,000 instead of $40,000.

I just want to tell you what women can do with a machine. We have a very good illustration of it. I don't mean a talking machine, I mean other kinds.

Our income tax returns, you know, are public property in Wisconsin. We don't stand for allowing a man to assess himself on incomes and compel the tax commissioner to become a star-chamber court where they have to go to jail if they tell a citizen whether or not the other fellow was complying with the law. Income tax returns are public and everybody takes it as a matter of course and I never yet have seen anybody injured by it.

Those income tax returns were put on the desk of the operator by a clerk in lots of 25 or 50. Inside of the current return were three other returns. The auditor, when he audited the current return, wrote in pencil the amount of the net income on the return, he also wrote on the return the amount for the two preceding years, because they had to be averaged and the assessment made on the average income.

A woman took this return, put it in the machine, and there was a place in the upper right-hand corner in which was typed the computations that were made. The three different years' income were put down, added up, divided by three, and the rates were applied to them. We have a graduated rate in Wisconsin from one per cent up to seven. Then we have a teachers' retirement fund surtax upon incomes over $3,000, and so a subtraction was made of the $3,000 from the net income and another computation made for the teachers' retirement fund surtax.

Then she took the return out of the machine, picked up the three that she had taken out of the inside and put them in and laid them down. That is the process.

Those women operated under a bonus plan, as I understand it, for the company which entered into the contract with us. Only we do know that the best woman, most speedy one, put, not 100, but 900 of those computations through that machine in a seven-hour day. It seems absolutely impossible to think about it. There are a great many other things that I might say, but this reference to the Kentucky governor I fear has kind of raised the ire of my friend, Dr. Martin, here, and I don't want to be in the position—because I think he has a gavel there somewhere—of the fellow who was

asked to speak at a large banquet, and consented. He was one of those fellows who liked to hear himself talk, and he thought he was quite a prominent pumpkin anyway, and perhaps he was.

But he was told when he got up that there were only a few minutes for him to talk. The few minutes were gone before he got warmed up, and he kept on going and gaining momentum as he went along. Soon the toastmaster got rather nervous and began to try to wink at him and make other signs that it was time for him to quit, but every time that he winked the speaker thought that it was in approval of what he had to say, and so he went on faster than ever.

Finally the chairman picked up the gavel and began to swing it, thinking he could attract his attention and by some sort of a movement of the gavel get him to sit down. But the speaker went on stronger than ever, and finally in swinging the gavel in desperation the toastmaster hit the fellow at the side of him on the head and knocked him down on the table. He squirmed around there for a minute or two and then he said, "For God's sake, hit me again, I can hear the fool talking yet."

CHAIRMAN MARTIN: Ladies and Gentlemen, we have about fifteen or twenty minutes now that can be devoted to general discussion. I may say that the chairman has been emphatically instructed not to permit this discussion to interfere with our prompt departure for Greenfield Village at two o'clock. That limitation will govern the handling of this discussion. Suppose, for that reason, we do not exceed five minutes in our discussions. Has anybody anything to say on the problems of research in assessments, either from a state point of view or from a local point of view? Is everybody satisfied?

SIMEON E. LELAND: There have been several of these projects running around over the country. They have one in Virginia. I am wondering if someone from Virginia would be kind enough to tell us something about the work they have done. Perhaps some of the other states have had something similar to this, and while they might not want to comment upon these other projects, which have been certainly carefully and thoroughly described, they might like to mention something that has gone on elsewhere.

Before I sit down I want to congratulate Mr. Champney on his speech and tell you that he did a darn sight better job over here for me than I did for him.

C. H. MORRISSETT (Virginia): Mr. Chairman, we have with us Dr. John H. Russell, who is a director of research in Virginia.

CHAIRMAN MARTIN: Dr. Russell, we are slipping up on your blind side.

John H. Russell (Virginia): Mr. Chairman, I was making motions here at Judge Morrissett, thinking that he would describe the work in Virginia, particularly for the reason that I have not been directly associated with it for very many weeks. My predecessor, Dr. William H. Stauffer, has been in charge of this project for about three years, I believe, and as has been said, in regard to other projects, the project in its early stages used something like 500 employees and collected descriptions of properties running up to 750,000 cards.

Those are preserved and on file and have been utilized by as many as six of our counties for beginning mappings. I am not sure that more than three of those mapping projects have been carried far enough to be of any substantial and practical service as yet.

But the part of our project that seems to me to be promising to result in the thing of greatest immediate value is that part which relates to collecting information upon assessment ratios in all the 124 local taxing units, the counties and cities.

There is information already tabulated and analyzed almost ready for publication. Dr. Stauffer still has that in charge, and as I understand, will soon have a report that we anticipate will be very valuable from the standpoint of showing what an assessment project of that kind will do.

We have segregation in Virginia, therefore the central tax commission at Richmond does not have any mandatory powers over the matter of assessments. Nevertheless, there is such cooperation going on between these local jurisdictions and the central tax commission as promises some very effective work in the matter of equalizing the assessments.

Certainly the information part of it is going to be carried out and the counties and cities will be given the benefit of their present standing. We are going to try to make indexes of the efficiency of assessment. We may not call them coefficients of dispersion, because that sounds rather technical and difficult to understand, but we hope to make an index of efficiency, or index of variation from the assessment ratios that the counties and cities are trying to reach.

I might say that it is almost a long stretch between the localities that have the lowest assessment ratios and those that have the highest. They run all the way from about twelve up to as high as ninety-five. I think that the information this project will furnish these counties, showing them how they stand and how assessments of their property may be improved, will be of great aid.

Chairman Martin: Many thanks, Dr. Russell.

Who will be next on this discussion? It would be interesting to have some comment on the method of recording. Is the addressograph type of record the most satisfactory type? Or is some other type of record to be preferred? That is an item that hasn't gotten

into the picture yet. Do you use the addressograph recording scheme, Dr. Russell?

MR. RUSSELL: No, sir, we haven't yet.

CHAIRMAN MARTIN: Do you use a machine type at all? Do you use a punch-card scheme or something of that sort, or no machine installation of the recording at all?

MR. RUSSELL: No, sir, we have not the machine installation.

CHAIRMAN MARTIN: Anybody else?

EDWARD R. LEWIS (Illinois): When you straightened out these descriptions, you must have found that there had been some land on which the owner had paid taxes and didn't know it and other land on which taxes had not been paid. In other words, the descriptions must have changed after taxes had been paid. Didn't you have your back tax record confused? Do I make myself clear?

MR. CHAMPNEY: Yes, I think I understand what you are referring to. Of course, naturally, in the preparation of new descriptions for property, we encountered some pretty serious problems. If we found that the overlaps and the title disputes were too warm in any particular area, we put on an assessor's plat and made separate lots of these disputed portions and let a race of diligence result between the conflicting entrants to decide who was going to pay us. That is the way we hurdled that particular problem.

JOSEPH E. FINERTY (Indiana): Do you use a key numbering device to attempt to control those pages as they come up or not?

MR. CHAMPNEY: Yes, the coding system to which I just referred hurriedly, is based on geographical identification. In each government survey section, the first two figures of the code number are the section. If it were section 12, the first two figures of the code number for any property located in that section would be 12. The subdivided property, the recorded subdivisions, are identified by a small letter, the first subdivision beginning in the northeast quarter being given A. So that lot 506 of subdivision A in section 12 would be 12A506. This sequence, of course, establishes the order in all the records, addressograph, mapping, and current files.

MR. FINERTY: After you establish that record do you attempt to use it in all your checking purposes or do you attempt to watch your legal descriptions for your checking purposes?

MR. CHAMPNEY: They are checked pretty largely through the code numbers. We use the legal description wherever it is required under the status, but we are developing tax records, tax collection records, particularly, and abstracts of taxes where we use only the code number, we don't use the description at all of course, it simplifies it greatly.

Mr. Finerty: Do you find that as efficient as the others?

Mr. Champney: Much more so, because we can teach people what a code number means where it is difficult to get them to follow an involved description. It is really quite simple, once they have familiarized themselves with the basis for the code number.

Mr. Finerty: The reason I asked that question, I am at the present time installing in Lake County a complete system such as you have, patterned somewhat after yours and somewhat after others that I have studied. We are setting up an account ledger for each piece of property, and I am setting up code numbers not exactly like yours, but along that same idea, and I am going to try to educate the public to keep those code numbers and do all my checking on those. I wondered whether you had found it efficient or not.

Mr. Champney: We find that even taxpayers are beginning to refer to their property by code numbers rather than the description. After they have received a bill one year, when they come back the next year they have that code number in mind and receive their tax bill on that basis.

That applies particularly to larger taxpayers with a lot of property. We have received letters from corporations now in which instead of listing long descriptions, they just give us our code numbers and we can give them the information immediately.

Chairman Martin: Is there any other comment or inquiry?

J. A. Scott (Minnesota): It may be of interest and perhaps of assistance to some of you for me to say that in 1910, 28 years ago, I installed a card system covering 100,000 descriptions of property. Those cards were in continuous use and answered every purpose for a period of 20 years. At the end of that time, I found that it worked, and I had printed another 100,000 cards and transferred the original set to a storeroom where they were available, and to which we referred every day.

In addition to that, I prepared a wall map 375 square feet upon which was shown the current assessed valuation of every piece of property in the city of Duluth.

In addition to that, I kept a record of every sale that was made and on this map as the sale was made, I made a little notation with a little letter S, showing that I had a record of such a sale. The result is that we now have on that map 30,000 sales to which to refer. The only thing that I can say about this plan is that it has worked. We have on these cards the assessment for each biennial or each annual valuation of every piece of property for that 28 years. We have a record of every transfer and the name of the grantor or grantee. So that we have a very complete record not only of what the assessed values have been but of what the record

of the property has been, who it has been transferred from, and the consideration.

I could go into more length about it but I know the time is up. If anyone is interested in a card system I would be glad to tell of our experience.

I want to say that since that time the two large cities of Minnesota, St. Paul and Minneapolis have installed a very similar set and I presume that at this time such a card system is not at all unique. But I think 28 years ago, in 1910, it was something of an innovation, because I was discouraged by those who said it wouldn't work. All I can say is that it has worked, so I think they were wrong.

CHAIRMAN MARTIN: Many thanks, Mr. Scott.

ARTHUR F. POTTER (Connecticut): May I inquire what is being done in Wayne County to insure that there will be a high grade appraisal of each of these same properties that are being surveyed? We have had several cases in Connecticut where we have had very high grade revaluations. We have also had several cases where the results have been unfortunate, and in most of those cases it was due to the fact that although they had a high grade gathering of factual data, there was not a translation in dollars and cents of that factual data by a competent appraiser. In some instances, after all the spade work had been done and the cards gathered, they were put aside and practically no good was accomplished.

How can you insure that there will be high grade appraisals after you have gotten your high grade factual data on your cards and maps.

MR. CHAMPNEY: I would like to say that we do no appraisal work in Wayne County through the WPA administration. None of the relief workers are used in the appraisal side of the work. They are engaged solely in the description and system preparation. We follow this up with property inventory through the regularly employed staff of the bureau of taxation.

I might say that if you are not familiar with the system here, that assessments are made by each township and city for all purposes, and we have in Wayne County 29 districts, 18 townships and 11 cities. There is no official unification of those districts, but we are attempting through the bureau of taxation to advise, instruct, and aid local assessors in using the information which is gathered through this county department intelligence. But we do not use any WPA help in that work.

CHAIRMAN MARTIN: Ladies and Gentlemen, despite the fact that we are having a good time, the hour has expired and the meeting is adjourned.

(The meeting thereupon adjourned at one fifty-five o'clock.)

TENTH SESSION

(DINNER SESSION—DEARBORN INN)

WEDNESDAY, OCTOBER 26, 1938, 7:30 P. M.

CHAIRMAN LELAND: If the management will get off these dishes or what is left of them as rapidly and quietly as possible we will begin our proceedings this evening with some customary announcements.

The first thing is that the executive committee will meet tomorrow at high noon at the registration desk, when its place to meet will be decided upon. We hope to have a quorum, so please remember that.

The next thing I want to call to your attention is the fact that the chairman of the nominations committee has asked the members of his committee to meet at the registration desk tomorrow morning at ten o'clock.

Are there any other announcements anyone wants to make? I haven't any more.

RAYMOND H. BERRY (Michigan): I have one, Mr. President.

Tomorrow at eleven o'clock buses will leave the Statler Hotel for the Chrysler Motor Car Company plant, Lake Shore Drive, and Belle Isle, for ladies only. Luncheon will be served at the Chrysler plant.

One more remark: Buses will leave the Dearborn Inn at ten o'clock or thereabouts returning to Detroit.

CHAIRMAN LELAND: I also have another announcement. The chairman of the nominations committee has now decided he wants that committee to meet at the end of the morning session instead of at ten o'clock. He doesn't get up very early. So the nominations committee will meet at the end of the morning session.

Now it gives me great pleasure to present to you one of our distinguished citizens of Dearborn. I say "our" because I have already joined the club here to support the next speaker in his new move. People who are members of the tax association run around a lot. We have Senator Edmonds running for state senator, we have Judge Leser running for the United States senatorship from Maryland, we have the distinguished mayor of Dearborn running for congress, and we have been reliably informed that there are twenty voters in the hall. So that I have joined the club to help out the situation and promote our mayor in his new move. I hope

he doesn't feel like my other friends here. I have offered to do a lot for them politically. I even offered to go to Pennsylvania and make a speech for Senator Edmonds, but he feels that if I went down there it would be a hopeless case. He has given me strict orders to stay not only out of his district but out of the state. I hope the mayor of Dearborn won't feel that way. He has been telling me some very interesting things about the city of Dearborn, about this general region. I have heard a great many interesting things about him. He is a real fellow. We wish him success in his campaign and in his new move to Washington, and it is with a great deal of pleasure that I present the Honorable John Carey, mayor of the city of Dearborn, who is also the donor of these handsome favors which have been presented to the ladies.

Mayor John Carey (Dearborn, Michigan): Mr. President, Ladies and Gentlemen, Members of the National Tax Association Conference: I find myself somewhat taxed for words because you know it is a tax on a public official a good many times to find what to say and when to say it, especially when those to whom you are talking are not from Texas.

You know, we are living in a rather peculiar age. It is the sort of age when you don't know what is going to happen next. Some of us don't care. It is the sort of an age when practically all of the raw material that we get comes from Hollywood. It is the sort of an age when it seems to take the striking figure of a heavyweight pugilist to prove that black eyes are beautiful only when given by nature.

You in this tax business are, of course, very interesting to us. We who pay taxes are also very interesting to you. We don't know whether we owe you or whether you owe us. We are somewhat like Bob Burns, old bazooka Bob, who has the famous Uncle Snazzy. Most of you have heard him. I sent this story to him; I don't know whether he is going to use it or not. I presume if he does he will say it something like this: my Uncle Snazzy was walking down on the seashore one day, and he saw a man down there on the seashore standing there just tearing his hair. He said to the man, "Mister, what are you so excited about?"

And the man said to Uncle Snazzy, "Mister, I don't know who you are or where you come from, but my wife and my mother-in-law are out there in the ocean and I am afraid they are going to drown. I will pay you $100 if you save my wife."

Uncle Snazzy didn't even stop to take off his shoes. He didn't even take off his coat or his pants. He just jumped in the water. He came swimming back with a woman, and when he dumped that woman on the sand the man looked at him and he said: "Mister, you saved the wrong woman. That is my mother-in-law."

Uncle Snazzy looked at that man and he said, "Brother, how much do I owe you?" (Laughter and applause)

So that is perhaps about the situation in which we find ourselves nowadays about it. About the only thing that we public officials really get any enjoyment out of is to be permitted to welcome you sort of people, you interesting people, you people who are trying to find out why taxes are taxes, why we should pay less and not more. At least, I hope that is what you are interested in.

So it is a distinct pleasure to welcome you here and hope that you enjoyed your visit to Greenfield Village. I hope you enjoyed your visit to the museum, and if you did not visit the Ford plant, it is probably because it would take you three weeks to really see it. There isn't any place else in the world like it. It would pay you to come back again. In fact, we would pay you to come back again if you would buy a Ford car. (Laughter) But we hope you have enjoyed it, and we have enjoyed it with you. The little favors I trust you will find useful. The book and the pencil I know you can use. You got keys to the city, too, but don't try to use them because you won't get anywhere with them. But you can keep them anyway and remember that we didn't lock you up, because we gave you the means to get back out.

Thank you.

Chairman Leland: The mayor has a few additional engagements for this evening, so I promised to excuse both him and Ray Berry—Ray on the condition that he will entertain the ladies who would like to avail themselves of the opportunity to go to the lounge or lobby and there enjoy the chairs and the atmosphere which may be more pleasant for them than the reports which they may hear or the speeches which we may make, interesting as they may be. So that if any of the ladies or any of the gentlemen would like to leave, this is a grand opportunity for you to make a getaway without any ill will so far as the officers and speakers of this session are concerned.

No buses are going to leave this place until this session is out, so that is one thing that is not going to do you any good.

The first speaker on the program this evening is Professor K. M. Williamson, professor of economics, Wesleyan University, who will discuss, "Reciprocity and Retaliation in Insurance Taxation."

There are few people who are so well qualified to discuss that very technical and involved subjects as Professor Williamson. It is one that has needed, it has seemed to me, a considerable amount of study, and Professor Williamson kindly agreed to look into it for us so that he might either refute or verify some of the suspicions that some of us have entertained as to just what reciprocity and retaliation meant as applied to this field. It gives me great pleasure to present Professor Williamson.

K. M. Williamson (Ohio): Mr. President, I am afraid those who didn't leave will be sorry they didn't, after they have listened to this, for, as you say, it is an extremely technical question, and I can't think of one less interesting after a good banquet meal like this, for the men as well as for the ladies. But President Leland asked for it, so here goes.

RECIPROCITY AND RETALIATION IN INSURANCE TAXATION

K. M. WILLIAMSON
Professor of Economics, Wesleyan University

This paper deals with an important feature of state taxation of foreign insurance companies. It will avoid confusion and indicate the nature of the subject of the paper to define certain terms as employed here. The term "foreign insurance company" will refer to a company doing business in a state but chartered by some other American state, and not a foreign country. The terms "reciprocity" and "retaliation" will be used to distinguish two different practices of the states in the taxation of such companies, and the adjectives "reciprocal" and "retaliatory" to designate respectively the methods employed in these practices. Under the reciprocal plan, as the term is used here, a state enacts no specified mandatory taxes to be imposed upon foreign insurance companies but provides that such companies should be subject to the same special tax laws and fees as are imposed by the states chartering such companies.[1] Under the retaliatory plan,[2] however, as that terms is used here, a given state, A, imposes upon foreign insurance companies doing

[1] The Connecticut law providing for the reciprocal plan in that state reads as follows:

"Every insurance company or association incorporated by or organized under the laws of any other state, and admitted to transact business in this state, and each agent of every such insurance company, shall pay the same fees and taxes to the insurance commissioner of this state as are imposed by such other state upon any similar insurance companies incorporated by or organized under the laws of this state or upon the agents of any such companies, transacting business in such other state." *General Statutes of Connecticut*, 1930, sec. 4150.

[2] As a typical example of the retaliatory provision of the law of New Hampshire may be cited:

"When, by the laws of any other state or country, any taxes, fines, penalties, licenses, fees, deposits or other obligations or prohibitions, additional to or in excess of those imposed by this state upon companies not organized under the laws of this state and their agents doing business in this state, are imposed upon insurance companies of this state and their agents doing business in such state or country, the same taxes, fines, penalties, licenses, fees, deposits or other obligations or prohibitions shall be imposed upon all insurance companies of such state or country and their agents doing business in this state, so long as such laws remain in force." *Public Laws of New Hampshire*, 1926; Chapter 275, section 53.

business within its borders its own primary or mandatory tax at fixed rates on legally defined bases, but provides that if any other state, B, imposes upon A's companies a higher tax, B's companies shall be taxed in A by B's law.[3] The retaliatory system thus assures the taxing state of a mandatory minimum tax and permits an alternative conditional maximum, while the reciprocal plan provides only for such charges as are fixed by the chartering states. The retaliatory plan of alternative taxes requires, however, burdensome comparisons of insurance tax laws and corresponding taxes, while the reciprocal system does not. It is well known that the predominant type of tax employed by the states in the taxation of foreign insurance companies is a per-centum charge upon premiums, and it will be understood that retaliation and reciprocity chiefly involve such taxes.[4]

The system of retaliation or reciprocity in state taxation of foreign insurance companies had its beginning in Massachusetts in 1832,[5] and at present is authorized by the laws of all states, except Arkansas, Florida, Georgia, Idaho, Mississippi, West Virginia, and the District of Columbia.[6] Of the states utilizing these devices, all except two employ the retaliatory plan throughout. The exceptions are Connecticut which uses the reciprocal method for all foreign companies, and New Jersey which employs that scheme for life companies only. Thus, of the two practices, retaliation is predominant.

There are many angles of this system of taxation which might be considered. The present paper, however, will be limited to four

[3] Considerable confusion, however, exists in the use of these terms in legal codes, court decisions, and in other literature on the subject. In some states, the plan referred to above as "retaliatory" is called "reciprocal", though the prevailing practice is to call it retaliatory. Though such provisions could, of course, be regarded as reciprocal in intent, they are not so in actual effect. The preference in some states for the term "reciprocal" for such provisions has been attributed to the desire to secure more liberal interpretations from the courts. See Frank Ewing, "Construction of Reciprocal and Retaliatory Statutes and Their Relation to Life Insurance," *Proceedings of Life Insurance Counsel*, Vol. 1, XXXVII, p. 10.

Even the plan called reciprocal in this paper is retaliatory in effect, though reciprocal in intent. For purposes of convenience in classification, however, I have referred to it as reciprocal.

[4] For information as to the different methods of state taxation of foreign insurance companies, see *Tax Systems of the World.*

[5] E. R. A. Seligman, *Essays in Taxation*, 9th edition, p. 162, and Ivan V. Snyder, "Taxation of Insurance Companies by the States," *Tax Magazine*, June, 1938, p. 371. New York, however, was apparently the first state, in 1865, to adopt a retaliatory form similar to those prevailing today. R. T. Byers, *Proceedings of American Life Convention*, 1908, p. 69.

[6] Based on information supplied by the federation of tax administrators and by insurance commissioners of certain states, supplemented by the *Tax Systems of the World*, 7th edition, pp. 204-205. Georgia is not included above because retaliation is there restricted to fees.

aspects of the operation of retaliation and reciprocity. (1) Their effects as instruments of protection of insurance companies in taxation. (2) Their relation to the problem of tax distribution. (3) Their efficacy as instruments for achieving uniformity and simplicity in taxation. (4) Administrative considerations. These topics will be discussed in the order mentioned.

1. Retaliation and Reciprocity as Methods of Tax Protection for Insurance Companies

One of the chief objectives of these practices in insurance taxation, as claimed for a long time by their advocates, is to protect insurance companies doing business outside of their home states from excessive taxation by the states in which they carry on their operations. It is contended that retaliation applied generally works in that fashion because when a given state imposes higher taxes upon foreign companies, other states, through retaliation, will impose correspondingly heavier charges upon the companies of that state. To increase the taxes upon foreign companies is, in effect, to increase the taxes on domestic companies. Hence, it is argued, the threat of retaliation leads home companies in various states to defend the foreign companies against heavier taxes, and legislatures to desist from imposing them. What does the evidence show as to the validity of this contention? In the first place, a survey of the changes in the state premium taxes on foreign life and fire insurance companies over the ten-year period, 1928-1937, inclusive, indicates, taking all states together, rather striking stability of rates.[7] During that period, the rates upon foreign fire insurance companies were raised by only nine states [8] and the District of Columbia, and upon foreign life insurance companies by only eleven states [9] and the District of Columbia. In view of the fact that this period included a time of great revenue strain and quest for additional revenue by the states, the absence of change in the rates of so many of the states is all the more remarkable. Moreover, most of the increases occurred in Southern or Western states. This geographical concentration of the changes is probably attributable to the fact that such states have too few companies doing business outside their borders for the retaliatory threat to constitute a serious deterrent to

[7] The information as to rate increases on which this statement is based is chiefly derived from the tax records of an insurance company doing business in practically all states, but has not been checked with the session laws of all these years. The source is, however, believed to be sufficiently accurate for present purposes.

[8] Alabama, Illinois, Indiana, Louisiana, Minnesota, Mississippi, Nevada, South Carolina, and Utah.

[9] Alabama, Arkansas, Idaho, Louisiana, Mississippi, Nevada, New Hampshire, New York, South Carolina, Texas, and Utah.

raising their taxes on foreign companies. Although other factors may account in part for the prevailing stability of the rates, it is probably true, as the insurance interests contend, that retaliation and reciprocity have had an important influence upon them.

More direct evidence of this influence of the retaliatory threat in keeping rates down is recorded in the case of some states. The experience in Ohio is a frequent illustration. In that state a rate of 2½ per cent upon foreign insurance companies which had existed for thirty-nine years was raised in 1927 to 3 per cent. In 1929 the rate was reduced to the original level of 2½ per cent. This reversal of policy was explained by insurance interests and others as due to the fact that the raising of the rate on foreign companies caused a marked increase in retaliatory and reciprocal taxes imposed upon Ohio companies doing business in other states.[10] New York State also affords another example. That state recently raised its rate upon life insurance companies from 1 to 1¾ per cent. An important consideration in favor of the limitation of the new rate to 1¾ per cent advanced by the New York commission for the revision of the tax laws which originally recommended this change was that such a rate would cause slight retaliation since it exceeded that of only a few states in which the business of New York companies was not relatively large.[11]

The reciprocal plan offers an additional form of protection to all the companies of Connecticut and to the life companies of New Jersey. These companies not only escape retaliation in the usual form, but, being subject only to the primary taxes of each state, they also enjoy in every state in which they do business as low rates as any of their competitors from other states. They are, thus, assured of as favorable tax advantages as are accorded to the companies of any state. Moreover, Connecticut life companies enjoy entire exemption from insurance taxes in New Jersey and those of the latter state escape also in Connecticut. The reciprocal advantages of this situation to the companies of these respective states undoubtedly militate against any effort to change it.

On the other hand, retaliation and reciprocity have failed to eradicate discrimination since several states are still imposing higher primary premium rates upon foreign than upon domestic companies.[12]

[10] H. F. Long in *Tax Relations Among Governmental Units by the Tax Policy League*, p. 73.

[11] *Report of the Commission*, pp. 33 and 187, and memorandum No. 13, p. 16.

[12] See *Tax Systems of the World*, pp. 204-205.

2. Relation of Retaliation and Reciprocity to the Problem of Equitable Taxation of Insurance Companies

Protection, however, as an aim in taxation may obviously conflict with an important objective of general tax policy — the equitable distribution of the tax burden. This possible conflict raises the question whether the taxes paid by the insurance companies under the systems of retaliation and reciprocity represent their equitable share of the tax burden. Although it is not the purpose of this paper to answer this question, it is well to point out that a conclusive finding is not easy to reach by quantitative investigation. The solution will turn in part upon one's views as to whether insurance should be favored over other business in taxation, or as to whether the taxes imposed are shifted to policy holders or not. Even if we assume, as does the present writer, that insurance should bear its proportionate share of taxation, further difficulties arise in determining what the comparable rates of burden should be. One difficulty is that of determining the basis of comparison. An important consideration in this connection is whether these taxes upon foreign insurance companies are to be regarded as porperty taxes or as business taxes. If they are held to be comparable with property taxes, then their rates should be substantially equivalent to property tax rates. This is apparently the conclusion of Dr. P. L. Gamble, a recent investigator of the comparative tax burdens on insurance companies, who says with respect to this point: "In many jurisdictions the major portion of public revenue is drawn from property taxes. To the writer it seems equitable and convenient that the taxation of insurance companies should be based on levies more comparable to real property taxes."[13] However, if one takes the view, as does the present writer,[14] that these taxes upon foreign insurance companies are to be regarded as business taxes, their burden should be comparable with that of other business taxes. In this case, however, comparisons of relative tax burdens are difficult because of the lack of a suitable common measure of burden in the absence of adequate data as to the true net income of insurance companies.[15] It is to be hoped that, despite these formidable difficulties, further research will reveal a satisfactory basis of determining the proper relative tax load for these companies. An objectionable feature of the operation of the retaliatory and reciprocal methods, however, is that they do not lead to a proper consideration of this problem.

[13] Philip L. Gamble, *Taxation of Insurance Companies*, Special Report Number 12, State Tax Commission of New York, 1937, p. 64. See for his comparisons of insurance taxes with other taxes, *ibid.*, pp. 42-59.

[14] *Proceedings of the National Tax Association*, 1934, pp. 396-397.

[15] With reference to the difficulties of obtaining the net income of insurance companies, see the writer's comments in *Proceedings of the National Tax Association*, 1934, pp. 396-397.

3. The Effects of Retaliation and Reciprocity as Instruments for Achieving Uniformity in Taxation of Insurance Companies

The other important aim of retaliation set forth by its supporters is to achieve uniformity in the taxation of insurance. Uniformity is, of course, an important objective of general tax reform today, and if retaliation and reciprocity do achieve this aim, such a result would constitute an attractive argument not only for their use in insurance taxation, but also for their adoption in other fields of taxation where they have not been tried. Already, in fact, some students of interstate conflicts in taxation seem to regard very favorably the effects of these practices upon uniformity in insurance taxes.[16] Thus, because of the importance of this contention, the emphasis of this paper has been placed upon an examination of its validity. It is admitted, of course, that all the states, with the exception of Massachusetts in the case of life companies, have adopted as the basis of their mandatory taxes on the foreign insurance companies some form of premium receipts. But it is probably debatable whether this unanimity in choice of base is due merely to the retaliatory system or to the disadvantages in the application of other measures in the case of insurance companies. It is true, also, that there is no great disparity in the per-centum rates of the taxes, and such approximate uniformity of the rates, like their stability already mentioned, is probably due to the retaliatory practice. Such uniformity of rates, however, will be considered as good or bad from the tax point of view depending upon whether or not they are regarded as exacting from the companies their equitable and appropriate shares of the aggregate tax burden. On the other hand, there is extraordinary lack of uniformity in other respects. The chief diversities and conflicts to be considered are of three kinds. (1) Lack of uniformity in the definition of the legal base of taxation. (2) Multiplicity of legal bases employed in a state operating under retaliation or reciprocity. (3) Differences between the states in the construction and application of retaliation. These several types of interstate conflicts will be treated in the order named.

The lack of uniformity in the legal definition of the premiums base relates both to specification of premiums taxable and to allowances for deductions. The current differences among the laws of

[16] For instance, Commissioner Henry F. Long of Massachusetts, recently gave it as his opinion that: "By and large, it is probably true that there is nearer approach to uniformity in the taxation of insurance companies than in the taxation of other classes of taxpayers. It would appear to be a proper deduction that this result has been largely influenced, if not directly brought about, by retaliatory provisions." Tax Policy League, *Tax Relations Among Governmental Units*, pp. 73-74. *Cf.* also the *Report of the New York Joint Legislative Committee on Interstate Cooperation*, 1937, p. 158.

the states with reference to premiums taxable have been summarized by a recent writer as follows:

> "Certain states declare premiums collected within the state to be the tax base; others take premiums on business done in the state; others, premiums received from residents; another makes its tax base all first premiums on business written in the state, and all renewal premiums received in or out of the state on lives in the state; another taxes all premium payments received in the state or remitted from the state to the home office; and finally, in Vermont, domestic companies are taxed on such of their gross premiums as are not taxed elsewhere." [17]

Such diversity in the premiums base can give rise to double taxation in some cases, escape from taxation in others, and costly additional record-keeping and reporting by the companies.[18] The diversities in allowances for deductions provided by the laws of different states concern the treatment of return premiums in the case of rejections and cancellations of policies, dividends paid to policy holders, losses paid within a state, and premiums on reinsurance contracts effected between companies.[19]

The differences in the practices of the several states with respect to deductions for reinsurance premiums is of special interest because of the volume of reinsurance transactions and of the effect upon reinsurance taxation of a recent decision of the supreme court relating to the matter. The practices of the states with respect to reinsurance allowances have been of three kinds. Some states allow a deduction for premiums on reinsurance received. Under this plan, the original company directly writing insurance is taxed on its premiums without any deduction for premiums paid to a reinsuring company on the business ceded to the latter, and the reinsuring company, in receiving a deduction for premiums received, is exempted from taxation thereon. This method is described as the direct writing basis. Under this treatment, no account is taken of reinsurance premiums at all. Some states, however, grant a mandatory deduction for reinsurance premiums paid, taxing the assuming company on the premiums received by it on the business ceded to it by the direct writing companies. This method has been called the net retained basis. Other states allow a conditional deduction to the direct writing companies for premiums paid on reinsurance ceded contingent on the payment of tax on such premiums by the reinsuring company. All states provide that there shall be no deduc-

[17] P. L. Gamble, *op. cit.*, p. 27.

[18] George B. Young, "Some Economic Aspects of State Taxation of Life Insurance," *Proceedings of the Association of Life Insurance Presidents*, 1923, p. 155.

[19] P. L. Gamble, *op. cit.*, pp. 27-30.

tion for reinsurance premiums paid to companies not admitted to do business within their borders.[20] At the beginning of this year, when the supreme court decision referred to was handed down, about 20 states had adopted the direct writing basis,[21] including the important insurance state, New York, which went on to that basis in 1937.[22]

Both double taxation and escape from taxation result from this lack of uniformity in the allowances for reinsurance. The double taxation of the reinsurance premiums can result from the combined operation of retaliation and diverse methods of allowances. Suppose that two companies chartered by state A do business in state B, and that A's law allows a deduction for reinsurance premiums paid and taxes reinsurance premiums received, while B's law provides for the direct writing basis. Suppose that one of these companies cedes business to the other. In this case B may tax the ceding company on its own basis allowing no deduction for reinsurance premiums paid, and may, by retaliation, subject the assuming company to A's basis with no deduction for reinsurance received. Thus, both companies would be taxed upon the premiums representing the reinsurance. If we change the conditions and suppose that a B company doing business in B cedes reinsurance to an A company admitted to B, state B in this case would tax its own company on the direct writing basis, and could, under retaliation, tax the A company on A's basis, thus again taxing the same premiums twice. Such results, of course, would depend upon the principle of retaliation followed, and may be attributed to retaliation as well as to diversity of bases. Escape from taxation may also arise from difference in treatment of reinsurance under the reciprocal plan. Suppose that company X chartered by a state having a mandatory deduction for reinsurance premiums paid and company Y chartered by a state on the direct writing basis both do business in Connecticut and that company X cedes business to company Y, Connecticut would lose revenue on the reinsurance premiums, since they would not be taxable to company X under its home state's law, nor to company Y under the law of its chartering state.

The decision of the supreme court in *Connecticut General Life Insurance Company* v. *Johnson*[23] rendered in January of this year, and already alluded to above, will, however, probably alter the abovementioned kind of diversity in the treatment of reinsurance premiums. This case involved the tax law of California which, like that

[20] P. L. Gamble, *op. cit.*, p. 29.

[21] H. F. Long, *Bulletin of the National Tax Association*, April, 1938, p. 207.

[22] *New York Laws*, 1937, Ch. 530.

[23] 303 U. S. 77 (Preliminary Print), January 31, 1938. See also for a discussion of this case, *Bulletin of the National Tax Association*, March, 1938, pp. 185-186; and April, 1938, pp. 206-208.

of many states, provides for a mandatory deduction for reinsurance premiums paid, taxing such premiums to the reinsuring companies receiving them. The Connecticut General Life Insurance Company chartered by Connecticut, having its home office in that state, and admitted to do business in California, had entered into contracts of reinsurance with other companies also licensed to do business in California, had received reinsurance premiums from these companies and was taxed upon such premiums in accordance with the California law. The company resisted these taxes and the supreme court upheld its contention, holding that California could not tax such reinsurance premiums because they represented transactions carried on outside of the state between the companies concerned since these contracts did "not run to the original insured." If this decision is to have validity in other states also, as it presumably will, it would seem to require the states, employing the net retained basis of taxation, to go over to the direct writing basis allowing no deduction for reinsurance paid, if they wish to tax the premiums on reinsured business. Otherwise, such premiums would not be taxable except, presumably, by the states in which the situs of the reinsurance contract exists. Since the Connecticut General decision several states have already amended their laws to place them on the direct writing basis,[24] and the authorities in some other states are reported as planning to recommend this change at the next sessions of their legislatures. Moreover, the taxation committee of the National Association of Insurance Commissioners had before the decision gone on record in favor of this basis.[25] Whether all the states will soon come into line remains to be seen. Meantime, however, there is considerable confusion on the part of the companies in their reporting for taxation and of the taxing authorities in those states which still remain on the net retained basis for the original insurers. According to my information, however, many companies are continuing to pay on the old basis, though under protest, thus insuring the states against loss of revenue until the laws are amended. Information is not available as to the extent to which other companies are pursuing different practices. In the interim, however, as some states change to the direct writing basis, while others lag behind, a disturbance of the *status quo* with respect to

[24] Among the states which have amended their laws to conform to the direct writing basis are the following: New Jersey, Virginia, Arkansas, California, and Kentucky. The California law will become effective as soon as the constitutional amendment validating it is approved. The amendment will be voted on in November. See *Bulletins* of the National Tax Association, April, 1938, p. 207; June, 1938, p. 268; and October, 1938, p. 18. A ruling was made by the insurance commissioner of Oklahoma this year to accomplish the change for the reports for 1937 business. *Bulletin*, National Tax Association, April, 1938, p. 207.

[25] *Proceedings* of the National Association of Insurance Commissioners, 1937, p. 216.

retaliation may prove serious. Retaliation may break out at new points in the interstate retaliatory relationships causing considerable increases of taxes for the companies of some states and perhaps reduction for those of others. Such retaliation might arise, for example, if a state remaining on the net retained basis should apply the direct writing basis to the companies of another state which has just adopted that basis, or if the latter state should retaliate against the former. Such retaliation due to shifts in legislation though very disturbing in the period of change would, however, cease after all of the states had adopted a uniform treatment of reinsurance. If all of the states are forced into a uniform method of treating reinsurance by the Connecticut General decision, the relevance of that fact for this paper is that the court will have accomplished what retaliation and reciprocity failed to achieve with respect to one of the most important conflicts in state taxation of insurance companies.

Quite aside from the judicial aspects of this shift to the direct writing basis, and the advantages in uniformity resulting from it, it may be remarked parenthetically that strong arguments may be advanced for the superiority of the direct writing basis if it is desired to avoid double taxation of reinsurance premiums. It is contended that the taxation of the original insurer on the gross business written without deduction for ceded business is more in accord with the concept of a franchise tax, and that this method has administrative advantages in that it obviates the necessity under the net retained basis of cross-checking of the numerous returns of companies to find if reinsurance premiums have been properly allocated to the state and returned for taxation by the assuming companies. Moreover, the taxes can be mutually shared by the ceding and assuming companies in the adjustment of their contracts.[26] It is also urged on the part of the companies that it will reduce the cost and inconvenience to them of record keeping for allocating and reporting the reinsurance transactions. The question arises, however, whether the states will lose any revenue by the shift to the direct writing basis. It is the contention of many insurance company officials that, though there might be a redistribution in taxes paid by individual companies, a state cannot lose revenue by the change since what was before taxed to assuming companies will after the change be taxed to the original insurers, the reinsurance premiums received being balanced by the reinsurance premiums paid. It is, of course, true that there should be no discrepancy between these

[26] Arguments of this kind are found in an unpublished Joint Memorandum of the New York Department of Taxation and Finance and the New York Department of Insurance submitted in 1937 in support of the change to the direct writing basis in that state, an excerpt from which was supplied to the writer, and in Brookings Institution, "Report on a Survey of the Organization and Administration of State, County, and Town Government of New Hampshire," 1932, p. 554.

two items except for errors by the companies in allocating reinsurance between the states, dishonesty in reporting, or accounting discrepancies at year ends. If these items are in balance, the contention would seem to be correct for states in which the rates upon domestic and foreign insurance companies are the same. On the other hand, in the case of states which discriminate between domestic and foreign companies, it would seem to be mathematically possible for a shift to the new basis to result in either a decrease or an increase of aggregate revenue depending upon the circumstances. This mathematical possibility arises from the fact that, though the reinsurance assumed and ceded by all companies in a state may balance, the amounts of business assumed by foreign from domestic companies and by domestic from foreign companies may not be equivalent. In a state in which the reinsurance premiums received by foreign from domestic companies exceeds those received by domestic from foreign companies, the change to the direct writing method would result in a *net* reduction of the aggregate taxable base of the foreign companies and a corresponding net addition to that of the domestic companies. Since, under discriminatory rates, the net increase in the base of the domestic companies will be subject to the lower domestic rate rather than to the higher foreign rate, such a state may under the force of arithmetic lose some part of its aggregate revenue from all insurance companies. Conversely, when such reinsurance relationships of the domestic and foreign companies are reversed, a state, with discriminatory rates, may enjoy a gain in revenue from the adoption of the new basis. These changes in revenue must, of course, be attributed to the feature of rate discrimination rather than to the change in the treatment of reinsurance. Data are, however, not available to the writer for estimation of the gain or loss of respective states from this factor. Some loss of revenue might also result from the fact that the double taxation shown above to be possible under retaliation when the states are employing different deduction allowances for reinsurance would cease with the adoption by all states of uniform treatment of reinsurance. On the other hand, any loss of revenue on the part of the reciprocal states, mentioned above as a present possibility, would be avoided by the adoption of the direct writing basis by other states. It is probably true, however, that, retaliatory rates aside, the states would, by and large, receive substantially the same revenue from their primary rates under the direct writing basis as under the former method.

Although it lies somewhat beyond the scope of this paper, it may be well to mention a further consequence which may follow from the Connecticut General decision. It has been noted by Commissioner Henry F. Long of Massachusetts that the decision may afford a legal basis for the taxation of the reinsurance business under the state franchise taxes, and he has suggested that the advisability of

that action be studied.[27] Such a tax would, of course, be upon the reinsurer at the situs of the reinsurance contract. This suggestion is based upon the interpretation that the court was asserting the doctrine that the reinsurance contract represents a separate and distinct transaction[28] taxable where executed. Under this doctrine, if it be the correct interpretation of the position of the court, the situs of reinsurance contracts would vary with the place of executing them. If the contracts were effected at the home office, the situs would be there; if, at the office of the agent, as often in the case of casualty companies, in the state where the agency is located. If, therefore, the reinsurance premiums received were, under this theory, to be made a part of the measure of the franchise of reinsurers, some conflicts might arise with respect to situs requiring cooperation for solution, for experience with retaliation does not offer much hope of a solution of such conflicts through that practice. Mr. Long argues that such a tax under the franchise principle could not be objected to on grounds of double taxation. An advantage of the proposal is, of course, that it would afford a basis for the taxation of companies, engaged solely in reinsurance, which under the direct writing basis of taxation of original insurers would pay no business taxes directly. Before the adoption of such a plan, however, the economic effects upon the salutary tendency towards distribution of risks through reinsurance should be carefully studied.

Thus far we have shown that retaliation and reciprocity have failed to eliminate the extraordinary lack of uniformity in the definitions of the premiums base. Besides failing to remove these diversities of the primary tax laws on foreign insurance companies, retaliation and reciprocity themselves increase the lack of uniformity by importing into a given state for the taxation of the foreign companies the multiple bases of taxation employed by the respective chartering states of the companies doing business within its borders. The result is that the several competing companies within a state are subjected to these varying bases and rates of taxation, requiring different methods of reporting.

A still more paradoxical effect of retaliation upon uniformity is that diversities and complexities are increased by the variations in the construction and application of the retaliatory provisions themselves by the states.[29] This lack of uniformity in the methods of

[27] H. F. Long, *Bulletin of the National Tax Association*, April, 1938, pp. 207-208.

[28] The Illinois Supreme Court has also held that reinsurance is a separate and distinct transaction. See *Union Central Life Insurance Company* v. *Lowe*, 349 Ill. 464 (1932).

[29] See for judicial constructions of retaliatory tax laws, P. H. Vartanian, "Retaliatory Tax Laws," 91 *American Law Reports*, pp. 803-817; Frank Ewing, *op. cit.;* and Robert L. Hogg, "Taxation of Life Insurance Under State Laws," Insurance Section of American Bar Association, 1938.

applying retaliation grows partly out of differences in the language of the laws, partly out of varying court decisions, and rulings by attorneys-general, and partly out of different interpretations by the insurance commissioners and tax authorities administering the retaliatory provisions. The writer has obtained information from some state officials as to their methods of applying their retaliatory laws, but this information being limited to certain states must be considered here as illustrative rather than exhaustive. It should be borne in mind, also, that the states undoubtedly vary in the rigidity of the application of their retaliatory laws. One state department, for example, has informed the writer that its policy, where possible, is to avoid retaliatory action entirely.[30]

One of the first points of difference in retaliatory practice is with reference to the primary prerequisite for retaliation. In the case of South Carolina, for example, the retaliatory law specifies that retaliation shall apply only in case companies of that state have agencies in the state whose laws provide taxes higher than those of South Carolina.[31] As a consequence, since South Carolina has few companies licensed in other states, the retaliatory law of that state is not applied in many instances.[32] When, however, the laws do not specifically limit the application in this way, some states about which the writer has information do apply retaliation even though they have no similar home companies licensed in the states against which they retaliate.[33] Under the latter practice retaliation sets in as soon as the higher taxes are enacted by another state. The writer does not know how general this practice is, but there appear to be many court decisions supporting such an interpretation of the condition for invoking retaliation.[34] It is scarcely necessary to point out, however, that retaliation, under this method of application, could be regarded only as protection against a possible future discrimination.

Differences exist, also, between the states with respect to discrimination between the foreign companies of a given chartering state. Some states, when the tax laws of the home state and the admitting state differ with respect to base or rate, require the foreign companies to render tax statements under both tax laws and apply in the case of each company whichever law yields the larger amount

[30] Letter from the New York Insurance Department.

[31] Act of South Carolina, No. 793, 1934.

[32] Letter from the Insurance Commissioner of South Carolina.

[33] An example of this practice is that of the insurance commissioner of Maine who recently attracted the interest of insurance companies by retaliating against New York casualty companies even though Maine has no company of that type doing business in New York. Other insurance tax administrators also report that they follow this practice.

[34] Frank Ewing, *op. cit.*, p. 15.

of tax.[35] Under this plan, the company is the unit of application of retaliation and not the entire group of a given class of companies (life, fire, or casualty) coming from a given state. This results in the application of varying laws of taxation upon the several admitted companies even of the same home state. The determination of the law to be applied as well as the amount of tax for each company is, thus, governed not by the laws alone but by the varying conditions of the respective companies as to losses paid or excess of reinsurance premiums paid or received, as the case may be, or as to other elements with respect to which deduction allowances are not uniform. This procedure is explained either by the wording of the retaliatory provision in some cases[36] or by the construction placed upon a wording which might be differently interpreted. Other states, on the other hand, construe their retaliatory provisions as requiring the all-or-none method, that is, the application of retaliation to all the admitted foreign companies of a given class of insurers, coming from a single chartering state.[37] Under this policy, retaliation will be invoked by the admitting state only in the event that the aggregate taxes of the entire group of foreign companies of a given class chartered by another state are greater under the tax law of the chartering state than under that of the admitting state. The result of this construction of the retaliatory provision is that the foreign companies of a given class from a single state will all be taxed by a uniform method, either that of the admitting or of the chartering state, as the case may be. The writer is not in-

[35] Instances of states following this practice about which the writer is informed are Massachusetts, New Hampshire and New Jersey.

[36] Massachusetts, for example, states that it regards its retaliatory provision as specifically mandatory on this point. See General Laws, Ch. 63, sections 21 and 23.

[37] This was apparently the construction placed upon the Indiana retaliatory provision by the Indiana supreme court even though other states, having essentially similar provisions, construe them differently. See *State v. American Insurance Company*, 79 Ind. App. 88 (1922). The Indiana retaliatory provision is in Burns Indiana Statutes (1938) 39-5012.

A similar construction was recently placed upon the California provision by the attorney-general of that state in a ruling given to the California insurance commissioner. The insurance commissioner found that some Indiana companies doing business in California would pay more tax under the California law and others more under the Indiana law, depending upon the extent of losses paid by each company, which is allowed as a deduction under Indiana law but not under that of California. The commissioner proceeded to apply the Indiana law to those Indiana companies for which it yielded the higher tax and the California law to the other Indiana companies for which the latter law resulted in more revenue. Indiana threatened to retaliate against California companies in the same way. The California attorney-general, on reference of the matter to him, ruled that the California provision required the application of retaliation to all Indiana companies of a given class, if to any. See *The Weekly Underwriter*, Insurance Department Service, 1935, California Section.

formed as to which of these methods of applying retaliation prevails among the states, but the necessity for rulings and court construction shows the confusion that can arise with reference to this point in the application of retaliation.

Another matter which has given rise to confusion in the application of retaliation by states is the treatment of local taxes on premiums. In the two cases involving this point the courts have held that, when an admitting state, in which such local taxes are permitted, invokes retaliation against the companies of another state, credit must be given to such companies against their retaliatory taxes for the amounts of such local taxes paid by them.[38] The writer, however, is unable to state whether it is now the practice of all admitting states to follow this construction of the retaliatory provisions. Conversely, retaliation may be invoked by an admitting state when another state permits such additional local taxes. When this is done, these local taxes will be added to the primary state tax of the other state in comparisons of tax laws and in the determination of the retaliatory taxes to be imposed by the admitting state. This practice is followed by at least one state about which the writer is informed.[39] Since, however, such local taxes do not exist throughout a given state involved and vary as between the different localities of such a state, the taxing authority of the retaliating state has to estimate the combined rate to be employed in retaliation. If the states uniformly follow this practice, the multiplicity of such local taxes increases the burden of administration of retaliatory provisions and adds to the compliance costs of companies.[40] Incidentally, the growth of such local charges or other special taxes[41] upon the insurance companies increases the lack of uniformity and adds to the evidence of the failure of retaliation and reciprocity either to remove or prevent such variations in taxation.

Difficulty has arisen for some insurance commissioners, also, with reference to allowing credits for real estate taxes in cases of retaliation. Instances of this have been noted in California and Montana. Montana law allows no credit against the premiums tax for real estate taxes paid in the state, while the California law does allow such a credit. In applying retaliation against a California

[38] *Life and Casualty Insurance Company* v. *Coleman*, 233 Ky. 350 (1930), and *John Hancock Mutual Life Insurance Company* v. *Pink*, 276 N. Y. 421 (1938).

[39] Massachusetts.

[40] See for comment on these local laws, F. J. De Celles, "Uniform State Taxes and Tax Laws," *Proceedings of the National Association of Insurance Commissioners*, 1936, pp. 80-86.

[41] An instance of such a special tax is that recently enacted by Minnesota in the form of a surcharge of 2 per cent to be imposed in certain cities for a limited period of time upon premiums for fire, lighting, and sprinkler leakage insurance to be contributed to Firemen's Relief Associations. Minnesota Laws, 1937, Ch. 109.

company, the Montana insurance commissioner applied the base and rate of the California law, but allowed no deduction for real estate taxes. In a suit which arose under this practice, the Montana supreme court held that there could be no such combining of different parts of the laws of two states in applying retaliation.[42] Similarly, in California the insurance commissioner of that state, perplexed by this same question, only recently required a ruling from the attorney-general of that state as to whether, in imposing the law of another state, he was required to grant a credit for the California real estate taxes, or for a similar credit in the law of the other state. In this case, the attorney-general ruled that, if the foreign basis of taxation is substituted for the domestic, it must be substituted entirely, credits and all.[43] These instances are cited to indicate that, though it is pointed out by legal authorities that court decisions reject the theory that domestic and foreign bases of taxation can be blended in applying retaliation,[44] the question seems to keep bobbing up.

A final instance both of the degree to which complexity may develop in the application of retaliatory laws and of lack of uniformity of treatment may be cited. In a recent case in the state of Washington it was held that when the law of another state is applied which provides for installment payments of the tax and this law is adopted in retaliation by an admitting state which provides for a lump sum payment of the tax, a credit must be allowed for interest lost to the company because of denial of installment payments.[45] In a case in Illinois, however, involving the same point, the court of that state held that no such credit was required.[46] In Connecticut, moreover, under the reciprocal system the attorney-general has ruled that the commissioner of insurance must collect reciprocal taxes from New York companies on a quarterly rather than lump sum basis since such quarterly payments are mandatory in New York. To what minutiae do retaliation and reciprocity lead! The purpose of the above survey of the varying constructions and differences in procedure involved in retaliation is to show that the very practice of retaliation in itself introduces confusion, complexities, and lack of uniformity into the taxation of foreign insurance companies rather than removes such features. If this is the lesson of the experience with retaliation and reciprocity in this field, tax reformers should be wary of expecting much from the adoption of similar practices in other parts of the tax structure. This con-

[42] *Occidental Life Insurance Company* v. *Holmes*, 80 Pac. (2nd) 383.

[43] *The Weekly Underwriter*, Insurance Department Service, 1937, California Section, pp. 39 and 46.

[44] Robert L. Hogg, *op. cit.*, p. 29.

[45] *Pacific Mutual Insurance Company* v. *State*, 161 Wash. 135.

[46] *Pacific Mutual Insurance Company* v. *Lowe*, 354 Ill. 398.

clusion would seem to be valid unless the failure to achieve uniformity by these means in the insurance tax field are to be attributed to unique characteristics of insurance taxation.

On the other hand, there are promising evidences of the beginning of a movement for the achievement of uniformity and the removal of interstate conflicts in the taxation of these important nation-wide companies through cooperation, both administrative and legislative. The most important of these developments is the recent activity of the National Association of Insurance Commissioners, the officials who almost universally are the administrators of the foreign insurance taxes.[47] The taxation committee of that association has studied not only the problem of a uniform base of taxation, but also that of the allocation of so-called "floater" policies which have no definite situs and in the taxation of which several states may have a claim. As has already been mentioned, that committee has recommended the direct writing basis as the standard measure for taxation, but, with respect to the problem of allocation of floater policies, it has made no definite recommendation, preferring to allow flexibility.[48] There are serious difficulties in arriving at equitable formulae for the allocation of such interstate insurance transactions as in the case of allocation of other bases of taxation but it is hoped that the insurance commissioners will make a further attempt to reach a solution in order to avoid the conflicts and double taxation, which may conceivably otherwise arise.

In addition to the work of its tax committee, the association has also adopted a new schedule T, so-called, to become a part of the standard blank for company reports. On this schedule each company will be required to indicate its aggregate business allocated by states. The new blank may prove valuable to the taxing authorities as a means of checking the tax returns made to the states.

The New York legislative committee on interstate cooperation is also making efforts to obtain greater uniformity in the insurance laws of the states. The writer has been informed that this com-

[47] Massachusetts is a notable exception. According to the writer's information, that state is the only one in which the state tax department is exclusively charged with the administration of the taxes on foreign insurance companies. Connecticut, in 1937, enacted legislation apparently intended to place the administration of these taxes in that state also in the hands of the tax commissioner. See 1937 Supplement to the General Statutes of Connecticut, sections 206d, 261d, 262d, and 263d. The method of drafting the new law, however, led to confusion, and the attorney-general ruled that the taxes should be administered by the insurance commissioner, but collected by the tax commissioner. The tax commission has accordingly recently recommended that the collection of the taxes be also restored to the insurance commissioner. Report of the tax commissioner to the secretary of the Connecticut Legislative Council, July 1, 1938.

[48] *Proceedings* of the National Association of Insurance Commissioners, 1937, pp. 216-217.

mittee is planning to hold a regional conference to that end early next year.[49]

The writer believes that cooperation of this kind may prove a more fruitful method of achieving uniformity and simplicity in the taxation of insurance than the practice of retaliation and reciprocity of the kind described in this paper.

4. Administrative Aspects of Retaliation and Reciprocity

Little remains to be said with respect to the administrative aspects of retaliation and reciprocity. It is obvious that the necessity of administering the multiple tax laws brought into effect in each state under these practices imposes a heavy burden upon the insurance departments if they are to be carefully and faithfully administered. A former insurance commissioner has said, at any rate, that "the bases of taxation are so varied and complicated that hundreds of companies file incorrect returns not necessarily through bad faith, but on account of the fact that no human agency could ever interpret accurately some of the laws that varying legislatures have imposed upon the insurance companies."[50] If the job of interpretation of the various laws is difficult for the companies, it must be equally arduous for the insurance commissioners. It is not a simple matter to administer a single tax law much less those of thirty or forty states. Unless, therefore, adequate tax personnel is provided for the insurance departments, it would seem that, under retaliation, in many cases a near approach to self-assessment by the companies would be the result.

In conclusion, we have found that, whatever advantages retaliation and reciprocity may have in preventing excessive taxation of insurance companies, these practices have not only failed to remove the lack of uniformity in taxation, but have actually increased it. In addition, these systems have greatly enlarged the burden of tax administration. It would, thus, appear that the disadvantages of these devices outweigh their advantages and that a more promising approach to uniformity in state taxation of foreign insurance companies could be made through the avenue of administrative and legislative cooperation.

Chairman Leland: I want to congratulate you, Professor Williamson, upon your admirable paper and the thorough discussion of this topic.

In thinking about some one to discuss Professor Williamson's paper, it seemed to me that we ought to look to someone in the in-

[49] Letter from the Council of State Governments, June 21, 1938.

[50] Mr. F. J. De Celles, *Proceedings* of the National Association of Insurance Commissioners, 1936, p. 81.

surance field to express their point of view, or at any rate their reactions toward the analysis which the speaker has just made. It seemed to me that no one would be more fitting to bring to this conference than someone from the National Life Insurance Company of Montpelier, Vermont, for among the very first members to join the National Tax Association was the National Life Insurance Company of Montpelier. So when I endeavored to find just who in that company should be invited, I learned very quickly that the one person best qualified to discuss the intricacies and the complications of reciprocity and retaliation was Mr. George B. Young, vice-president of the company. It gives me great pleasure to present him to you now.

Mr. Young!

Discussion on Reciprocity and Retaliation in Insurance Taxation

GEORGE B. YOUNG

Vice-Pres. National Life Insurance Company

Professor Williamson's excellent address has presented such a complete and accurate account of these statutes and their operation that there is little to be added to what he has said. I have been asked to make a few comments from the standpoint of the life insurance companies. What I may say must not be construed as an expression of the opinion of life insurance companies but simply as my own individual views.

When the states began to supervise and regulate life insurance it was deemed proper to tax the companies enough to meet the expense of supervision and taxes were assessed on that theory. That idea was long since abandoned and today the life insurance companies seem to bear their full share of the costs of government, as they should.

It is estimated that the life insurance taxes, licenses and fees, state and local, company and agent, in 1937 amounted to approximately $60,000,000 exclusive of real estate taxes of about $50,000,000.

When the retaliatory laws were first enacted they were undoubtedly designed to protect the home company against discrimination by other states in which they might do business.

In *State* v. *Reinmund*, 45 Ohio St. 214, the Ohio court said:

> "In other words, our law is protective in its character, its purpose being to protect Ohio insurance companies from imposition which might be put upon them by other states."

In the case of *People* v. *Fire Association of Philadelphia*, 92 N. Y. 311, the court said:

> "The evident purpose of the act is to treat the corporations of another state seeking to transact business here precisely as such other states should treat our own corporations seeking to do business there."

Soon after these statutes began to be passed the question of their constitutionality arose. In Alabama where the question was first considered the supreme court held the act unconstitutional, as being a delegation of legislative authority to the authorities of some other state, but in other states the constitutionality was sustained and the acts have been recognized as valid and have been in force now for many years.

These statutes apply not only to taxes, fees and charges but to the admission of companies, the provisions of contracts, the number and kinds of insurance that foreign companies may write, and other matters of regulation and prohibition.

Talbot v. *New York Fidelity & Casualty Co.*, 74 Md. 536, is an interesting case on this point. Under the law of New York the New York commissioner in the exercise of his absolute discretion had denied admission to New York of a Maryland company and thereupon the Maryland commissioner under a retaliatory act denied a license to a New York company to do business in Maryland. The New York company brought suit claiming that since the New York statute gave the New York commissioner authority to decline a license to a foreign company when in his discretion it was best for the people of the state of New York that it be not admitted but that the Maryland statute gave no such discretion to its commissioner, the Maryland commissioner could not properly under the retaliatory act deny a license to the New York company. The court said:

> "We cannot agree to the view pressed with so much earnestness and ability by the appellee's counsel that the exclusion of the Maryland company from New York State by the refusal on the part of the New York superintendent to allow its license was not a prohibition by the law of New York within the meaning of our statute. The law of New York vests such absolute discretion in its superintendent of insurance that it is within his power to exclude every Maryland company from working in New York State, if in his judgment it was not in the interests of the New York people to have companies of other states to compete with insurance companies of that state. Now it is perfectly clear that our lawmakers never designed that our statute should be so interpreted as to allow New York companies to have access to our state on the same terms as our own while ours cannot be allowed in New York State."

A little different application is shown by *State* v. *Fidelity & Casualty Co.*, 77 Iowa 648. There a New York company sought permission to do several lines of insurance in Iowa. The Iowa law then allowed companies to be organized in Iowa only to do one class of business. The law of New York prohibited a foreign company from doing more than one class of business and therefore when the New York company applied for a license to do more than one kind of business in Iowa the commissioner denied permission to do but the one kind. This suit was brought to test that ruling. The court, among other things, said:

> "The law of New York in terms prohibits an insurance company organized under the laws of Iowa from making in New York more than one of the kinds of insurance made by the defendant in this state and that law of itself places on the statute books of Iowa the law that the defendant being an insurance company organized under the laws of New York can make but one of such kinds of insurance in this state. . . . It is urged in argument that a company organized in Iowa could only make one of such kinds of insurance here, because it would be prohibited from doing more by our law and hence the law of New York does not prevent it from doing in that state what it could not do in this under Iowa law, but we fail to see how that reaches the question. It is not the question that New York does as well by Iowa insurance companies as Iowa itself does, but does New York deny privileges to Iowa companies or perhaps in better terms, does it impose prohibitions. If so, the same prohibitions are imposed in return as against New York companies."

In a New Hampshire case of *Haverhill Insurance Co.* v. *Prescott*, 42 N. H. 547, where a Massachusetts company which had not complied with the retaliatory statute by qualifying to do business in New Hampshire in the same way that a New Hampshire company would have to qualify in Massachusetts, the Massachusetts company issued a policy insuring property in New Hampshire and took a note for the premium. Later when it attempted to enforce the note in the New Hampshire courts it was denied the right of recovery because under the retaliatory law it had not done in New Hampshire what a New Hampshire company would have to do to authorize itself to write business in Massachusetts.

While these statutes do deal with prohibitions and various regulations, their chief concern is with taxes, fees and charges. As applying to this phase of the retaliatory statutes the courts have said:

> "The purpose of these laws is to equalize the amount of taxes which are required to be paid under different state laws."

and again:

> "We think it very plain that the object of the statutes is to make the rate of taxation under this section no more burdensome upon foreign companies here than the like rates upon companies of Massachusetts doing business in a foreign state."

In the case of *Life & Casualty Insurance Co.* v. *Coleman,* 233 Ky. 350, Kentucky invoked its retaliatory law against a Tennessee company. The Kentucky law permitted the municipal taxation of insurance companies while Tennessee did not. It was contended by the Tennessee company that in determining the amount to be paid to the state of Kentucky credit should be given it for sums paid to Kentucky municipalities. On this point the court said:

> "Our conclusion is that the provisions of the retaliatory tax statute were complied with when the Tennessee company paid an amount equal to the total tax payable by a foreign company on the same volume of business in Tennessee. In determining the amount to be paid the Tennessee company must be given credit for municipal taxes paid in Kentucky."

This doctrine has more recently been approved in New York in the case of *John Hancock Mutual Life Insurance Company* v. *Pink,* 276 N. Y. 421, and the rule seems to be now generally recognized that the admitting state, if it applies the retaliatory law, must take the tax laws of the domiciliary state of the company involved as a whole. There has been some tendency to take the more disadvantageous features from the standpoint of the company of the laws of the two states and combine them into a new tax law different from that of either state, which would make the company pay a larger tax than either state required. This cannot be done. If the retaliatory act is applied, it must take the law of the state of the home of the company as a whole.

The result is that the company whose home state has a high tax rate and a minimum of deductions and extensive regulations and prohibitions is most adversely affected by the retaliatory laws, and conversely companies from those states which have a low rate and a maximum of deductions and a minimum of regulations are the least affected by the retaliatory acts.

One of the things that was hoped to be accomplished by these acts apparently was uniformity, but uniformity has not been the result. The base of the tax in the various states is so different that there is no uniformity whatever among the different states. For instance, the tax base in some states is gross amount of premiums collected or contracted for, gross amount of premiums received, all premiums received, gross premiums written in the state, gross premiums less returned premiums, and other expressions varying to the extent that hardly any two states have exactly the same base for the tax. There is also a wide difference in the deductions,

some states allowing from the premiums the deduction of death claims up to a certain percentage of the gross receipts; reinsurance premiums; others, all dividends, all dividends applied, and various other modifications and variations of the deductions. There is also a wide difference in the rates. With these various modifications premium tax statutes affecting foreign life insurance companies are in effect in all but three states. Approximately one and three-fourths per cent of gross premiums collected by all life insurance companies is taken in this form of tax, but the construction of the tax statutes themselves has raised many questions, as must appear from the various descriptions of the base of the tax and the deductions. As to the rate there is a wide variety, ranging from no stated tax in Connecticut to three per cent of the gross amount of all receipts in Indiana. One and a half, two per cent, two and a half, and two and a quarter are the varying rates, up to three per cent.

The result is that almost every company in filing its returns in the various states has to compute the tax under the law where the tax return is being filed and under the law of its home state in order to determine under which law the tax has to be paid. This defeats uniformity and increases the expense to the companies. It seems to me that there has been no real benefit to the companies or to the states from these retaliatory acts. I believe that the states would be as well off and the companies much better off if the retaliatory and reciprocal statutes were done away with and a uniform state law could be adopted, making a uniform base for all of these premium taxes and if possible a uniform rate of taxation. This would accomplish all that these statutes were ever designed to accomplish, would yield as much revenue to the states and simplify the making of returns and the payment of taxes by the companies. It would greatly simplify the administrative duties of the commissioners, because then in each state they would simply have to determine the tax by their own law and not by other laws and they would not have to check every return to see which law gave the greater tax. A uniform state law giving a uniform base and a uniform rate would be the ideal method for taxing life insurance companies.

Chairman Leland: Mr. Young, I want to thank you for that very clear and interesting discussion.

Are there any people who would like to raise any questions or to discuss this topic in any way? We have a few minutes before we need to proceed to the report of the committee. We would be glad to listen to any questions.

Frontis H. Moore (Alabama): With special respect to the constitutionality of these loans, in the '90's,—'98, I believe,—our supreme court held that the retaliatory provision was unconstitu-

tional on the theory that it was delegating to the legislature of another state the right to legislate for Alabama. No attempt was made to collect the tax following that, but notwithstanding the decision, each successive legislature continued the retaliatory clause in the law. Some insurance commissioner about 1926 or 1927 attended a convention and heard the retaliatory provision discussed again, so he came back and started to enforce it. The supreme court immediately followed the decision of twenty years before, without any particular opinion, just affirmed it on the authority of the old decision.

My affirmation is that there has been no effort made to enforce it, but very able lawyers have argued that the decision of the supreme court was erroneous and opposed to the general law throughout the United States. At any rate, that is the situation in Alabama.

There is one question, though, that I would particularly like to ask Dr. Williamson. Our law provides for a tax on gross premiums without any deduction for re-insurance, gross premiums less returned premiums. The question of what are returned premiums pops up on every occasion, some of the companies claiming, so I am advised by the commission, that that means dividends, the commission claiming that it means cancellations, actual returns. If you can give me some law on that I would be very appreciative.

Mr. Williamson: Mr. President, Mr. Young is a lawyer. I will turn that question over to him.

Mr. Young: I believe Alabama is the only state that has held that statute unconstitutional. The question has been raised in a number of other jurisdictions. It has always been sustained as a constitutional statute. The decisions in Alabama still stay, as you have stated. This question of returned premiums is one of somewhat uncertain status. That appears in some of the statutes and it has been claimed to be dividends included within it. I think they might properly be, although more technically it probably is a premium return on an account of cancellation or collapse and return in some other way.

Of course, this question of the application of dividends in reducing the term "gross premiums" has been before the courts in a number of the states. I think the general rule has been that dividends applied are not counted in getting at gross premiums received. Premiums that are paid in cash and the dividends paid back in cash are included.

Chairman Leland: Does anyone else have a question? We can settle some lawsuits, maybe.

It gives me great pleasure, then, to move on to the next topic on our program. One of the interesting questions which the federal form of government raises in connection with interstate business is,

what will you do with an income which is earned in more than one place by a business that gets its raw materials from one state, manufactures them in another state, ships them to branches in a third state, has wholesalers and jobbers in other states, sells its products to consumers who move about from place to place, and who are called upon to meet the tax commissioners of 48 states annually to divide up what is left of their net incomes. The very nature of our business and commerce today is such that there are few problems of as great moment as the state taxation of interstate business. So important did that topic appear last year that a committee was created by the National Tax Association to study the problems involved in the allocation of income.

It gives me great pleasure to present Mr. Leo Mattersdorf, of New York City, the chairman of that committee, who has been working diligently with the problems and with the help of his committee during the past year.

Mr. Mattersdorf!

PRELIMINARY REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON ALLOCATION OF INCOME

LEO MATTERSDORF, CHAIRMAN

In 1937, at Baltimore, on the occasion of the thirtieth national conference on taxation the following resolution was adopted:

> "RESOLVED, that this conference request the National Tax Association to appoint a committee to give further consideration to the question of allocation of income for state income tax, in the hope that further progress may be made in the direction of uniform legislation and administrative practice, and to promote comity between the states in income tax administration." (*Proc.*, 1937, p. 528).

Pursuant to this resolution the president of the association appointed this committee, and defined its scope to embrace "not only the problems of allocation for state income taxation but also the general problems of allocation as they arise under the property tax, special taxes upon intangibles, the corporate excess, franchise, and similar imposts." The scope of the committee's studies is, therefore, a wide one, and in view of the fact that the problems dealing with a uniform formula of allocating for the income tax, for franchise taxes, for the property tax, for special taxes upon intangibles, or for other taxes, are not alike in many respects, it was decided to undertake the study of one problem at a time and it began with the one which to it seems the most important, namely, the question of allocation as it affects income taxes and franchise taxes measured by

income. This committee is studying a method for uniform apportionment of income between the states and the term "allocation" is used in that sense in this report.

This is the fifth committee to which has been assigned the problem of studying the possibilities of uniformity in allocating income between the states and of recommending a formula which would accomplish the desired result. It seems advisable, therefore, to review briefly the results of the studies and the recommendations of these earlier committees.

Results of Studies of Previous Committees

The Model Plan of 1919:

A committee was appointed in November 1916 to prepare a model plan of state and local taxation. The plan was explained and discussed at the 1919 conference and thereafter two model bills for the taxation of personal incomes and business incomes were prepared and were printed in the *Bulletin* of the association for January 1921. The allocation method included in the model business income tax provided for the apportionment of the total net income of business corporations among the states on the basis of tangible property and gross receipts within and without the state, property being weighted at two-thirds and receipts at one-third in the fraction.

Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Businesses—1922:

In 1920 and 1921, two committees were appointed to consider the allocation problem: one committee devoted its attention to mercantile and manufacturing corporations while the other dealt with public utilities. The committee on the apportionment of business taxes made its report in 1922, while the committee on taxation of public utilities and upon the interstate apportionment of the tax reported in 1923.[1]

A. *1922 Report:* The 1922 report of the committee on the apportionment between states of taxes on mercantile and manufacturing business proposed a new plan of allocation which was based upon the two factors of tangible property—real and personal—and business, each of which was to be weighted at 50 per cent in the fraction (*Proc.*, 1922, p. 198). The business factor was to be measured by (a) purchases of materials and supplies,[2] (b) payroll, and (c) receipts from sales.

[1] This committee recommended the adoption of a composite apportionment fraction to consist of the following factors: all track mileage, car mileage, physical valuation, traffic units and gross earnings. *Proc.*, 1923, p. 410.

[2] The 1929 committee questioned the advisability of including purchases, stating that the job of allocating income would be greatly simplified by the elimination of purchases.

In computing the amount of income subject to allocation, it was provided that interest, rents, dividends and royalties received in the regular course of business should be specifically allocated to the state in which they were received; and that gains from the sale of capital assets, used in connection with, but not in the regular course of business, should be allocated to the state in which the assets were located. The remainder of the net income was subject to allocation according to the proportions which the tangible property and business within a state bore to the total tangible property and total business.

At the 1922 conference, the following resolution was adopted:

> "WHEREAS, it is recognized that a uniform rule of apportionment, for taxation purposes, of the net business income of mercantile and manufacturing concerns, whose business is conducted in no one state, is essential, in order that fairness and equity may prevail,
>
> THEREFORE, BE IT RESOLVED, that the Fifteenth National Tax Conference hereby urges the adoption of a uniform rule by states, calculated to fairly and equitably apportion such net business income."

Committee on Simplification of State Taxation of Business Concerns, 1925:

In 1925, a new committee on simplification of state taxation of business concerns was appointed to investigate the variation in laws or the varying interpretation of the laws among the various states in which a single business unit may be transacting business and owning property "to the end that appropriate remedies for interstate or inter-county complications in the taxation of business organizations, whether corporate or individual, may be devised and suggested to the various states at a future conference."

A. *1926 Report:* The first report of this committee was made in 1926. Attention was directed to the chief difficulties involved in the allocation problem, among which were the following: the unsatisfactory condition of the law of taxable situs, variety and kinds of tax laws, and of the interpretations of laws of the same kind, ambiguity in the laws, the degree of administrative latitude permitted by the laws, etc.

The committee stated in reference to the 1922 recommendation for a model allocation fraction, that the "present committee feels that this fraction did not win universal approval. Your committee is not prepared to suggest a substitute at this time but believes that further special study should be given to the matter, to arrive at a fraction that would be correct in principle and that would, therefore, be likely to receive general approval." (*Proc.*, 1926, p. 159).

Preliminary reports were made by this committee in 1927 and 1928 and an exhaustive report was made in 1929.

B. *1927 Report:* At the 1927 conference a report of the committee was directed chiefly to an outline of the 1919 report on a model system of state and local taxation, the comments that had been made upon it, what had happened to the model drafts, and a few brief recommendations relative to standardization and simplification of business taxes.

C. *1928 Report:* At the 1928 conference the committee presented a copy of the model laws as drafted in 1921, noting thereon all of the suggestions that had been made in previous discussions. In addition, parts of the business and personal income tax law were rearranged and footnotes were inserted to indicate criticisms and suggestions that were made relative to the model provisions at the various annual conferences.

D. *1929 Report:* At the 1929 conference a very excellent report was submitted by the committee. The subject matter of the report centered around the results that should be accomplished by the ideal fraction. The following four results were set forth and discussed: (*Proc.*, 1929, pp. 155-159).

1. The same fraction should be used by all the taxing jurisdictions in order that a corporation will not be taxed on more than 100 per cent of its net income or of its capital stock value.
2. In order that the same valuation may be acceptable for use by all the states, it should be one that comes as near as possible to allocating the total net income to the several states, as the net income would be allocated if a separate business unit reported the income for each state.
3. The fraction should be so reasonably simple and definite that it can be readily ascertained by the taxpayer and the tax administrator.
4. The allocation fraction must not run contrary to the principles governing taxation growing out of the federal constitution.

The committee did not recommend any particular fraction but stated that "no committee, however learned in the principles of accounting and of constitutional law, should at this time recommend an allocation fraction unless it has first ascertained the experiences of administrators and taxpayers with allocation fractions now in use." (*Proc.*, 1929, p. 161). The committee made a survey of state allocation practices which were included in an appendix.

At the 1929 conference the following resolution was adopted:

> "Resolved, that the conference recommend to the National Tax Association the appointment of a committee to investigate the subject of uniformity and reciprocity in state and local taxation, to report to the next conference."

When this task was assigned to this committee it appreciated the fact that since the question of allocation of income had been studied before it would be advisable to approach this problem from a new angle and also determine, if it could, why the suggestions made by previous committees had not been more generally adopted. It was also felt that in order to arrive at worth-while conclusions detailed studies would have to be undertaken. This is the spirit in which the National Tax Association functions and which makes its findings of value to those interested in problems dealing with taxation.

Before proceeding further with a statement of the committee's activities thus far, it would be well to re-assert certain axioms which form the basis for any conclusions which may be reached on the subject. The committee on the apportionment between states of taxes on mercantile and manufacturing businesses went on record in 1922 with the statement that "The members of the committee are all agreed that, from the standpoint of the taxpayer, uniformity between states is by all odds the most essential requisite. It might make little difference to the taxpayer whether he is taxed on seventy-five per cent of his income at the place of manufacture and twenty-five per cent at the place of sale, or vice versa, so long as he is taxed only on one hundred per cent altogether." While some of the statements made to this committee in its studies would seem to question the fundamental soundness of that statement since persons making such statements feel that mathematical formulae do not often result in a correct allocation of income to certain states as compared with figures reflected in their books, it is felt that, nevertheless, those statements are made because of the effect of lack of uniformity. It is fair to assume that if uniformity were an accomplished fact, all other things being equal, such as the burden of taxation, the taxpayers would probably be unanimous or nearly so in their acceptance of the conclusion reached by the committee in 1922.

But what of the various formulae recommended by previous committees of the National Tax Association? There seems to be no doubt but that they were probably as fair and equitable as any that have ever been proposed or been written into law. Yet it is a matter of experience, as has been stated, that in spite of recommendations made by these committees composed of men recognized as authorities in the field of taxation, the great forward step hoped for has not materialized. The committee feels that among the reasons, one is that the formulae heretofore recommended are applicable to the apportionment of income of only two types of business, namely, manufacturing and mercantile. In a state where activities of this type are not predominant, it is natural to expect that the legislature would be loath to adopt such a formula, for the simple reason that that formula would affect only a very small part of the taxpayers engaged in business in that state. To put it another way, why

should state A write an allocation formula into its income tax statute affecting manufacturing concerns if in the whole state of A there are but few manufacturers?

It is possible, therefore, that the solution *may* lie in the use of several formulae based on a classification of taxpayers by types of business. This recommendation is not made as yet. The committee has not had time to study it, but it presents much food for thought and, incidentally, many new problems. If, for instance, it were possible to place all business in this country, let us say, into six general classifications, and if a fair formula for allocating income were adopted for each such classification, and each state adopted the six formulae, grouping the taxpayers within it according to those classifications, we would have a type of uniformity which would be equitable to the taxpayers and would not result in unfairness or loss of revenue to the states. If an agricultural state, for example, adopted all these six formulae, a manufacturing corporation doing business there would be permitted to use the formula for manufacturing corporations. If the same formula for manufacturing corporations were applied elsewhere such corporation would be taxed on no more than one hundred per cent of its income and the agricultural state we are speaking of would have no particular objection to the use of such formula because most of the corporations, carrying on the predominant type of business in such agricultural state, would be allocating their income under a different formula acceptable to that state.

The problem is not as simple as that. Corporations do not engage in one type of business in all states or, for that matter, in one state. Some even have no preponderant type of business. There is no assurance that each state would classify the same corporation in the same manner. These are problems which this committee will continue to study and for which it hopes to find a solution.

In passing, it might be interesting to mention a suggestion which has been made to secure uniformity in the application of a single formula to the same corporation, if this proposal of several formulae were adopted. It is that a board be appointed to be composed of a given number of members, no two of whom could be citizens of the same state. To this board appeals could be taken by taxpayers or states for final rulings on classifications in which corporations should be placed. That suggestion was made not only in the committee but independently by one of the tax commissioners. There are difficulties in the way of the adoption of this proposal, but it seems worth mentioning and thinking more about. Several of the states have used such commissions for other purposes in the past and are using them today. For instance, the states of New York and New Jersey, by compact have created the Port of New York Authority which has general jurisdiction over the bridges and tunnels over and under the Hudson River which form part of the boundary between the

two states. Provision is made for jurisdiction of the courts of each state over traffic violators on the bridges and in the tunnels, and other matters.

It might be stated, too, that there are other problems which although they do not concern the question of allocation of income, result in lack of uniformity. Net income is defined differently in different states. The tax rates vary considerably. There is a general lack of jurisdiction with respect to income from interstate sales where a company maintains no place of business in the state. It is also absolutely impossible in the case of many taxpayers to determine anything other than an arbitrary tax base. Aside from that, there have been instances lately, we regret to say, where jurisdistions smaller than states, (and, we exclude the District of Columbia from that category) have been empowered to levy taxes on gross or net income. Since the widespread adoption of any such policy will defeat any attempt at uniformity in allocating income, the committee does not approve this practice and urges the several legislatures to prohibit it.

As has been already pointed out, a previous committee reporting in 1929 stated that "no committee, however learned in the principles of accounting and of constitutional law, should at this time recommend an allocation fraction unless it has first ascertained the experiences of administrators and taxpayers with allocation fractions now in use" (*Proc.*, 1929, p. 161). Early in its deliberations the present committee decided that in order properly to study the question of allocation of income and to obtain as much information as possible on the subject, it should address inquiries to determine the ideas and experiences of the state tax commissions of states which have income tax laws and franchise taxes measured by income, and of those corporations which do business in several states. It is manifestly impossible to address a questionnaire to all corporations in that category so it was agreed that the various committee members should send the questionnaire to those of their acquaintances connected with corporations doing business in several states. In addition, this questionnaire or a form of it was addressed to the American Institute of Accountants and the Controllers Institute of America and was printed in their respective publications.

Not all replies from state tax commissions had been received at the time of the writing of this report and many have been received too late to make a detailed analysis possible and to report thereon to this conference. With respect to the questionnaire addressed to corporations, most of the replies which were received reached the committee so late that only a very sketchy analysis can be made at this time. Many corporations have not yet replied, although they have indicated that they will do so a little later on.

The questionnaire to tax commissions was addressed to those of the following thirty-four states:

Alabama	Iowa	Montana	South Carolina
Arizona	Kansas	New Mexico	South Dakota
Arkansas	Kentucky	New York	Tennessee
California	Louisiana	North Carolina	Utah
Colorado	Maryland	North Dakota	Vermont
Connecticut	Massachusetts	Oklahoma	Virginia
Delaware	Minnesota	Oregon	West Virginia
Georgia	Mississippi	Pennsylvania	Wisconsin
Idaho	Missouri		

It was also addressed to the comptroller of the city of New York and the commissioners of the District of Columbia, since both of those jurisdictions have gross receipts taxes. While these taxes are not based on net income, it was felt that much interesting data could be obtained from these jurisdictions.

Tax Commission Questionnaire

As has been stated, the committee can comment only briefly on the replies to the tax commission questionnaire to date, since it would be impossible, in view of the limited time at its disposal and the fact that some states have not yet replied, to arrive at any definite conclusions.

The first question addressed to the tax commissions is as follows:

> "Will you please tell the committee what formula for allocating corporate income is used by your state and how long it has been in effect?"

No comment will be made thereon at this time except to say that there are more than twenty different formulae in existence in the several states.

The second question is:

> "Have any changes been made in your formula since the original adoption of your law? Why?"

The purpose of the question is to determine, where such changes have been made, if the reason was that the old formula worked unfairly one way or another. Such data would be of decided help to this committee because the experience so gained by a state in the actual use of a formula since discarded is the best evidence that it should probably not be recommended. There is very little that can be reported at this time with respect to the answers to this question.

The third question is:

> "Based on the experience of your commission, will you please tell the committee what you think are the features commending your formula as well as the features which you believe to be unsatisfactory?"

Many states point out that one of the chief objections to their particular formula is that it is impractical and even impossible to apply it to all types of business. This bears out the committee's idea that one formula cannot be used universally to allocate income between the states. Other states complain that it is very difficult to apportion sales to the particular state where that element is one of the factors to be considered. Favorable features mentioned by the states for their particular formulae include, among others, that where several factors are used the formula is more apt to be upheld by the courts, that the formula has the advantage of definiteness and standardization, and that it allocates income on the basis of factors giving rise to income. The tax commission in one state where a variation of the Massachusetts formula is used points out that "The principal advantages of our formula are the ease of checking the factors included therein against the balance sheet and the statement showing total net income, as well as the almost universal use of formulae of this type among the various states having income tax laws. The latter is important both because of the familiarity of the taxpayer with the formula and, also, because the department is able to follow regulations and court decisions of other states." This is probably the best argument for uniformity which could be advanced.

The fourth question is in two parts, as follows:

> "(a) To what type of business is your formula best suited?
> (b) To what type of business is it least suited?"

Naturally the replies vary considerably, but it is worthy of note that with respect to the Massachusetts formula the states using it, or a form of it, generally feel that it is best suited to manufacturing and mercantile corporations and least suited to financial corporations, service corporations, contractors, etc. The committee will have to give further study to the replies to the two parts of this question before it can come to any conclusion as to the type of formulae or procedure it should recommend.

The fifth question is:

> "To what extent is separate accounting permitted and used for the purpose of allocation of income?"

The purpose of the question is to determine how extensively this method is used since it seems apparent that if it were possible to keep books properly, it would be an ideal method for allocating income no matter what the type of business and thus many difficulties would be overcome. As experience is the best guide, there can be no doubt but that the answers with respect to this question should be very illuminating. The investigation of this subject has not been completed. Many of the states use the method, or prefer, or encourage it, while others discourage it or do not permit it. Where it is used or permitted, it is necessary, of course, that the records of the corporation be accurately kept and the income equi-

tably allocated to the various jurisdictions. More will be said about this when discussing the questionnaire sent to corporations.

The sixth question is:

> "In your state, is there any constitutional limitation which prohibits the delegation to the state tax commission of the formulation of a formula for allocating income, or, in case there is a statutory formula, is there a constitutional limitation prohibiting the state tax commission from making an equitable adjustment in the formula, or adopting a special formula in the case of a taxpayer to which it does not equitably apply?"

The reason for asking this question was that there have been cases in the state of New York decided by its highest court, the court of appeals, which hold that a mere delegation of authority to the commission "to equitably adjust the tax upon the basis of the corporate activity or the business done within and without the state" rather than upon the segregation of assets shown by the report where the commission felt such a segregation did not properly reflect the activity of the corporation in New York was void since "it is too vague to state a workable rule." (*People ex rel. Ducas Co., Inc.* v. *State Tax Commission*, 260 N. Y. 525, 184 N. E. 77; and *Eitingon Schild Co., Inc.* v. *Lynch*, 260 N. Y. 526, 184 N. E. 77.) The implication is that, in using other than a statutory formula, the commission was exercising a legislative rather than an administrative power, and that is unconstitutional. That state, therefore, cannot use any method or formula except one provided for in the law itself. The committee naturally was anxious to determine what the experience in this respect has been in other states since if this situation obtains to any great extent the approach to uniformity by the states will have to be different. It is apparent that many state tax commissions did not comprehend the purpose of the question but it seems that the issue has not been raised in most of the states and also there is a feeling among many of the tax commissions that they have the power to adjust the tax equitably on the basis of any formula which appears to be just and fair whether prescribed by law or not. It might also be stated that the constitution of the state of New York has very little in it touching on the subject of taxation and is about as broad in this respect as any that can be found in the Union.

The seventh question is in three parts, as follows:

> "(a) Would your commission favor a uniform allocation formula for all the states if a single formula were adopted for all taxpayers, regardless of the character of their business or activities?
>
> (b) Would your commission be in favor of having the several states adopt, and does it believe it is possible to adopt, uniform formulae for allocating income, the formulae being

> applied to classes and types of taxpayers or businesses? In other words, if taxpayers or businesses were classified as to manufacturing, mercantile, service (such as advertising, commission brokers, etc.) financial and agricultural and different formulae were suggested for each type of business, does your commission think it practical to adopt these formulae and then apply the applicable one to each particular corporation, depending upon the classification in which its business, as carried on in all states, falls?
>
> (c) Does your commission prefer uniformity under (a) or (b) above?"

Most states from which answers have been received have signified that they prefer uniformity on the basis of several formulae. Many of them have indicated that the idea of using several formulae to attain uniformity is logical and feasible, while a minority have indicated that the administrative difficulties would be insurmountable. Some of the comments on uniformity based on one formula only are "utterly impossible", "unwise", "improper", "unfair" and "not feasible".

The eighth question is:

> "If your state now treats differently, for allocation purposes, a domestic and a foreign corporation engaged in the same line of business, or treats differently, for allocation purposes, two corporations engaged in exactly the same line of business, except that the activity in your state may, in one case, be the selling of merchandise manufactured by the corporation in another state, or the manufacturing of merchandise in your state sold elsewhere, would your commission be agreeable to recommending to your legislature that taxpayers of the same type be taxed in the same manner, no matter what their state of incorporation or particular activity in your state happens to be?"

This question was asked because there are a few states which make these distinctions in applying allocation formulae. Most states make no such distinction. The committee hoped to determine to what extent a state would cooperate in the adoption of a uniform formula or formulae for allocating income, for the reason that uniformity cannot be obtained if these jurisdictions continue making such distinctions. Some of these states indicate that they will not make the recommendation to the legislature.

The committee is happy to report, however, that nearly all the states have shown a spirit of cooperation and a willingness to be of assistance in furthering the solution of this problem. It feels that this augurs well and that the cause of uniformity is not hopeless.

Corporation Questionnaire

The questionnaire addressed to corporations consists of four questions only. In distributing this questionnaire the committee en-

deavored to reach as many types of businesses as it could but, as has been stated, only a relatively small number of replies have been received and it would be impossible at this time to draw any definite conclusions. It can, however, briefly comment on the purpose of the questions and make some statements based on the replies received to date.

The first of these questions is:

> "What formula for allocating corporate income between the states, if used by all the states, would be particularly fitted to your business? Please give reasons."

The purpose of the question is obvious. Many corporations find fault with the use of the sales factor in allocating income, principally because there are so many methods used for determining to what jurisdiction sales should be allocated and, hence, there is much overlapping. It is interesting to note that some of the tax commissions have stated that many of their administrative difficulties arise from the same cause.

The second question is:

> "Do you approve of apportionment of income by a mathematical formula or do you approve of a direct accounting method based on your books? Please give reasons."

It is noted that even in the case of large corporations many of them do not favor the use of the direct accounting method. One of the main objections seems to be that the books are not now so kept that they will readily reflect income by jurisdictions and it is felt that it is more difficult and costly to change the books in this respect than to obtain information for the many mathematical formulae now in use. Those that use the separate accounting method think that it is the only fair one. The committee desires to point out at this time that it realizes that no mathematical formula will work exact or even-handed justice. On the other hand, if uniformity were obtained, it is felt that that very fact would lead to substantial justice in allocating income and that is all that can be hoped for in any tax law.

The third question is:

> "How many different formulae is your business now required to use because of its activity in several states and how much more work do you estimate it necessitates to prepare the figures for these formulae, than if one formula were in use by all the states levying a tax based on income?"

The purpose of the question is, of course, readily apparent. The replies so far received indicate that the use of different formulae varies from a few to all those used in the United States, and there is also great variance in the additional time required to prepare the necessary figures.

The fourth question is:

> "On what functions of your business do you believe it earns its income and what percentage of the income earned do you assign to each function? In other words, how much of the income earned by your business do you believe is due to the function of selling, to the function of purchasing, to the function of investment, etc.?"

The reason this question was asked is because there was a feeling in the committee that there might possibly be a way of devising a satisfactory formula if it were based on functions of a business resulting in income. While some of the members of the committee do not believe that this is possible, it certainly appears worth while to obtain information on the subject. The replies are not yet numerous enough to indicate what the answer will be, but it seems that such a formula would be difficult to administer because of the impossibility of determining what function of a business results in profits. For instance, a corporation which manufactures an article for which it also must purchase some parts and which then sells the completed product, probably could not very easily determine what part of the profit it eventually earns is attributable to selling, to purchasing and to manufacturing. It can be conceded that while the sale itself results in realizing the income or in making it an accomplished fact, that income could not be earned without the prior manufacture or purchase of the article. The committee will have to leave to a later report any definite statements as to the possibilities inherent in this phase of the subject. However, the answers may give an idea as to what weight to give to factors entering into any formula or formulae this committee may recommend.

Since the committee has not had time to conclude its studies on the subjects assigned to it, there has been handed to the secretary of the conference a resolution calling for the extension of the life of the committee.

Respectfully submitted,

C. B. Allyn
W. R. Bradley
E. M. Elkin
Robert S. Ford
Carl S. Lamb
Thomas C. Lavery
Edward R. Lewis
Henry F. Long
John J. Merrill
Arthur F. Potter
Henry Rottschaefer
Leo Mattersdorf, *Chairman.*

Chairman Leland: The next order of business is a discussion of this report. The first person to lead the discussion will be Mr. J. W. Huston, director of the legal and research division, department of finance, Illinois.

Comment on Preliminary Report of the Committee of the National Tax Association on Allocation of Income

J. W. HUSTON
Supervisor, Legal and Research Division,
Department of Finance, Illinois

The problem dealt with in the excellent report just submitted to you is one which is fundamental in a federal system where 48 sovereign states are permitted to tax the same object—in this case business income. Considerations of efficiency, simplicity and equity are laid against the inherent right of the states to tax as they see fit. Since each state is sovereign within fairly wide limits we face the task of persuading each state to shape its income tax law to avoid the overlapping which results when the same dollar of business income is taxed by more than one jurisdiction. Or, in the absence of voluntary state action we may turn to coercive methods through some sort of federal action.

The committee prefers the first alternative — that of achieving uniformity through voluntary state action (interstate compacts) and thus seeks to avoid federal interference which would insure uniformity at the expense of making the federal government supreme in yet another field. And the committee is probably correct in its judgment that the solution of the allocation problem by congressional action would be a serious impairment of "states' rights." There is nothing more essential to sovereign power than the free right to tax any object of taxation in the state's jurisdiction. For congress, even indirectly through a crediting device, to prescribe the details of a state tax law means that still another state prerogative will have moved to Washington. It means, in short, that every state would be moved to adopt an income tax law, and that law would be prescribed by congress. The estate tax credit and the social security act have operated with great success in causing death duties and payroll taxes to be enacted by the states in forms which might not otherwise have been adopted.

While I realize the implications of federal control as much as the committee, I cannot bring myself to believe that the states themselves will soon voluntarily impose uniformity in allocation formulae, or other methods of apportioning business income, upon themselves. As a state tax administrator I have had occasion to appear before legislatures and this may be the reason for my pessimism. Legislatures are frantically looking for money to spend these days (this is no criticism of them) and a proposal which might limit the ways and means of raising money by limiting the particular means

of apportioning taxable objects to their states would be difficult to put through. This is especially true when it is understood that the principal beneficiaries of such a plan would be the large interstate corporations. We must remember that probably the most important reason for diversity in allocation formulae is that each state will tend to adopt the formula which will result in the most tax for it. A manufacturing state will favor the use of tangible property and payrolls in its formula, while an agricultural state will favor sales or gross receipts.

The committee suggests that one reason for the lack of acceptance of formulae recommended by previous committees of the National Tax Association is because such formulae have applied only to manufacturing and mercantile corporations. It is indeed true that a single formula is inapplicable to diverse types of business. But to date, states have shown no conformity to a single rule even in allocating the income of manufacturing and mercantile corporations which are the most common type they have to deal with.

Tax administrators, too, feel that they should be free to apply special rules in special cases. Any administrator knows how many perfectly proper exceptions must be made to any general rule, or to put it another way, how many "unusual cases" arise. Administrators would examine any proposed interstate compact with the greatest care to avoid any undue rigidity it might impose upon them. It is of course unnecessary to add that the more latitude given administrators the less chance there is of achieving uniformity in allocation between the states.

The cause of uniformity is therefore faced with a dilemma. It can be solved by the states relinquishing some jurisdiction to congress. Or it can be attacked by voluntary state cooperation. I have indicated my very serious doubts concerning success of the latter method. It seems to me that in the end we must make the choice between continuing the present lack of uniformity indefinitely, or seek to solve the problem through federal action. I express no opinion as to whether the problem needs solving badly enough to warrant such a solution.

CHAIRMAN LELAND: The next discusser is Mr. A. J. Oehler, comptroller of the S. H. Kress & Company, of New York City.

Comment on REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON ALLOCATION

A. J. OEHLER
Comptroller, S. H. Kress & Co.

The report of the present committee on allocation has been added to a list of at least 10 prior ones on this and related questions, since 1919, nearly 20 years ago. While we regret that the committee

thus far has been unable to propose a solution to this complex problem, it is hoped that it will be continued, for its report reveals a broad understanding of the problem, a scientific approach to its solution and an open mind.

The ultimate goal of the attack on this problem is equitable taxation, a vital issue today, though more particularly in federal taxation. The number one issue of the day is, of course, expenditure control. It may be urged that the question is not under consideration at this session of the program but we insist that the lack of expenditure control is largely responsible for this and almost all major problems of taxation, in that the high rates of taxes and multiplicity of tax laws were and are necessitated largely by lack of control of expenditures. The national debt, according to recent estimates has reached the appalling figure of over 60 billion dollars. This figures out about $1,800 per family of four. Since a debt or judgment is only as good as the debtor, and according to a recent department of commerce survey two-thirds of the family incomes in 1935-36 were less than $1,450 each, the liability of those of us who remain solvent is today not less than $5,000 for each of our average families. It has been stated that much of this national debt represents a transfer from private to public accounts. Unfortunately, my private debts have not yet been transferred and I am reasonably sure that yours have not. The danger of our public debt lies, not in the total, staggering as it is, but in the very political psychology which is responsible for the rapid increase in the debt as well as newer and more fantastic panaceas to accelerate our course to final national insolvency. Though history contains no recorded actual cure by such treatment, the standard prescription since 1930 for social and economic ills is to spend other people's money with the accent on "spend" and "other."

Thus taxes have multiplied in numbers and magnitude, offset credits have been eliminated, increased federal and state income taxes are disallowed as deductions, to mention a few contributing factors, so that inequities of tax laws have grown from relatively unimportant variations to imposing injustices. Add to this the new "Rube Goldberg" principle in the drafting of tax laws, purposes other than for regulation or revenue, and an attitude of some officials who justify their positions of inconsistency in interpretation by the fact that two or more taxpayers may each take different positions on the same question, and you see what distresses the taxpayer today.

Representing an interstate corporate taxpayer in the mercantile business, I have made some observations which may or may not add light to this discussion.

Though we have found the members of the various state tax commissions usually sympathetic and ready to adjust inequities of their particular laws and allocation formulae, the committee has cor-

rectly observed that some may not deviate from a fixed statutory formula. The adoption by all states of uniform allocation formulae would result in taxation of a maximum of 100% of the base. If satisfactory formulae were possible and allocation were obligatory in all states, little complaint would arise on the part of taxpayers, and such as did arise would result perhaps from the wide variation in tax bases and rates.

A single universal, practical, and equitable allocation formula for all types of business and all varieties of taxes is, in my opinion, simply not possible to prepare. The committee has indicated some of many reasons why this is so.

Assets within a state may indicate a company's investment within the borders of that state and serve as a measure of so-called capital stock taxes, but they do not necessarily measure earnings within the state. We have properties which yield a high rate of profit and, unfortunately, other properties which are actual liabilities. The investment of money in a store or factory location does not guarantee a fixed rate of return or any return. The same logic applies to sales or gross income. And what about percentage of total salaries and wages as a basis of allocation? Obviously, net profit varies inversely with expenses assuming a given gross profit. Thus, other things being equal, the higher the salaries and wages paid the lower the net profit. There is no assurance that by averaging two or three of these factors the inaccuracies will offset each other. Two or more erroneous assumptions do not necessarily combine to produce a correct conclusion, nor even an essentially approximate one.

It thus appears that an approach to consistent accuracy can be made only by direct or semi-direct accounting, and resort to allocation of general factors only. It is our observation that the most scientific formula for allocating income now in use for our type of business is the Mississippi formula, which allocates gross merchandise profit and all indirect income and expenses on the basis of landed cost of sales, crediting direct all other income and charging direct all direct expenses. Since other things being equal, net profit varies directly with gross merchandise profit and indirectly with cost of sales, I believe the substitution of a sales factor for cost of sales factor would make this the nearest approach to a simple practical formula for allocation of income for the mercantile business.

In many states, certain items of income such as rents, dividends, royalties, etc. have been treated as direct and not subject to allocation. Why not apply this theory to all items of direct expense? Salaries and wages, rents, depreciation and amortization and state and local taxes constitute about 60% to 75% of the expenses for mercantile organizations and are subject to wide variation in different states and sections. All are subject to quick verification and audit by state agents.

Our company operates in 29 states and the territory of Hawaii. Our 1937 direct taxes, state and local (after crediting sales taxes collected), vary from .67% to 4.35% of sales within the states. In some southeastern states great emphasis is placed upon state, county and city regulatory and privilege taxes. Corporations may pay a license or franchise tax for doing business within the state, another license for operating as a chain store, another for operating a store, another for operating each major department, perhaps one or more licenses for selling certain merchandise within certain departments, as for example, electrical goods, auto accessories, etc.—in some cases similar levies being made by various taxing jurisdictions. Other states levy few or no such license taxes. The Pacific coast states have minimum wages far above those of the southeastern states. To maintain or hope that any arbitrary allocation formula will equalize such differences and equitably allocate earned income under such conditions is to credit the chosen formula with supernatural powers. So we repeat, that the Mississippi formula because it does recognize such variations, is for our type of business the most logical and practical simple formula yet suggested.

The ideal situation would be one in which all states adopted a uniform tax system, rates and allocation formulae. However, the most the committee appears to hope for is uniformity of allocation formulae, probably voluntarily adopted by all states. I am convinced that under existing conditions, no less than four and possibly not more than six classes of interstate business must be recognized and allocation formulae developed for each class.

And may I say that I feel this is as much a problem of mathematics as one of economics. In any case it certainly is idle to talk of solving and reconciling the many variables of modern interstate business with a single simple allocation formula of one, two or even three factors.

Even if such procedure did not further jeopardize state rights, I personally doubt that collection of all taxes by the federal government with appropriate refunds or credits to the states would be practical, for the proper basis of such refund would still involve "allocation."

Incidental to the adoption of uniform formulae by the various states, the question of administration and interpretation would be minimized to the great benefit of interstate taxpayer and collectors alike.

Twenty years of study of this subject by eminent experts within and without this association has yielded no acceptable solution. Even a casual observer must come to the quick conclusion that here is an intricate problem which will yield to no simple solution. No formula should be expected ever to approach 100% efficiency, but a closer approximation to true tax liability of interstate taxpayers is

daily becoming more and more important as a greater and greater percentage of the earned dollars go to the tax collector.

CHAIRMAN LELAND: The person who has had most experience in the matter of allocation and whose methods and formulae have been most widely imitated, adopted and refined, Henry F. Long, of Massachusetts, is the next person scheduled to discuss this very fine report.

HENRY F. LONG (Massachusetts): Mr. President, in the seven minutes that I am permitted it would seem to me best now that all of you understand clearly what net income is, what allocation is, what formulas are, what numerators and denominators can bring about, and what the result should be, that the best thing for me to do is to try to muddle it up a bit, so that you will think you have really sat in on an intelligent meeting.

After all, the thing that we are seeking—and as tax administrators we represent the taxpayers as well as the tax-gatherers—is something which approaches fairness in taxation. Every single tax administrator, no matter how lowly he may be, has from the beginning of time undertaken to find a yardstick. The yardstick is very elusive, and while the taxpayer who thinks in terms of simplicity in taxation would like to find a yardstick which would be uniformly operated, we know very definitely that it isn't going to operate.

The second observation I want to make is that in taxing those who come within our states, we are primarily motivated by the thought that the foreigner within our gates should be treated as fairly as the citizen of our state, therefore we have made constantly an effort to find something which would treat them both fairly.

The next two observations I want to make are perhaps a little apart from the subject. The first one is that we are of the opinion as tax administrators, aside from the legal aspects of it, that the person coming within our gates to compete with our own citizens is entitled to no more consideration than is the citizen of our state, and while we may work out some kind of a mathematical computation which could be called a yardstick, the net result of that must of necessity be a tax which is neither unfair nor of advantage to the citizen who is foreign to our particular jurisdiction.

Perhaps at that point I might add that what a tax administrator always wants is to contact the taxpayer—assuming that there are none in the room that this would apply to — not the lawyer or accountant who is concerned only with his relationship to his client and is disregardful of the place which the tax administrator occupies in the field of public finance.

If we talk with the taxpayer we get as tax administrators what we think is the best result, namely, what is a fair tax in the eyes of the taxpayer. We very frequently feel that by the adoption of

a mathematical formula which has to be mathematical in its very character, that we are widening the gap between ourselves and the taxpayer. The accountant of necessity seeks something which has a certain amount of exactness to it, and he and perhaps others dream of the day when taxation will be a science, which to most tax administrators is something which is in the very distant future.

He believes that in the last analysis the only thing that the taxpayer is interested in is not fairness, is not a legal law, is not something that is constitutionally sound, is not something that is scientific, not something which can be worked out with exactness, but a bill which he thinks fits into his cost of government. In other words, all that he is interested in or can be interested in is what is the tax bill?

The method of reaching it may be the most ideal in the world, but it will not be satisfactory unless the result is one that meets his thought as to the exactions that should be put upon his particular activity. I think that is perfectly sound, right and proper. Therefore, it is my thought that while we should make every possible effort to see that the citizen and the non-citizen doing business in our state shall be equally treated, we should not bind ourselves so much with formulae and with mathematical attempts that we bring about a result which to most taxpayers is most confusing.

There isn't any difference between taxing a corporation on its net income, that is a foreign corporation in its domicile, than the relationship that we are going to have right around the corner in most states with personal income taxation, where the non-resident earns income within a state and that state taxes him with some kind of reciprocal relation with other states, and in working out the thought that we may have in regard to attributing to each state in which this individual may conduct his business. We are ultimately to work out not a yardstick which is good to operate in every instance, but only something, call it formulae or what you may, that will give us a starting point to reach that which ultimately is the thing that we are striving for, namely, a tax which will keep that particular industrial activity within our state, and one which will not drive him out, one which will not be discriminatory and one which will yield a fair amount of revenue for that particular activity within the state.

There isn't an accountant in this room—and we have the cream of the accountancy right here—who can't take any tax law of any single state in this union and take the accounts of his own company and make the result of his calculations bring a different result in one state than it will in another merely by the system of accountancy. Why, some of the tricks that an accountant can make a set of figures do are simply so marvelous that they are astounded themselves at the results they get.

They are always very anxious to bring about a result that is fair, but as one tax administrator I surely do not want ever to reach the point where the determination of revenue as to a given state is going to be in the last analysis resolved as to what can be brought about by an accountancy figure.

In Massachusetts, when we adopted the income tax as a measure to determine the corporate excess on corporations, we started with two general principles. We had for many years a tax on foreign and domestic corporations quite different, with the foreign corporation having a distinct advantage over the domestic. But with the adoption of a uniformity between the two corporations, and the necessity of including income as a measure of trying to find what the corporate excess or the privilege of being a corporation within the state was fairly to be, we had to think in terms of what was the best way to allocate income.

We take the term "net income"—and it is to be noted that this particular committee has undertaken to go back into the figures that made up net income, we recognized the particular difficulty which we would get into — therefore, we start with a net income figure, not with a thought that that is a correct amount, but merely because it is an amount from which we can start, leaving to others the determination of whether that base is a proper one from which to take our flight into our efforts to fairly assess or tax that particular net income.

The first step that we take is that there should be only just so much tax on this particular net income, and that one state shouldn't get any more than another and that generally we shouldn't ask a corporation to pay too much in one state. There immediately came to the minds of the persons framing the law in Massachusetts three elements which seemed to be generally present in the corporations which then were of concern in Massachusetts. Those elements were sales, without which a corporation couldn't exist, tangible personal property, without the use of which the manufactured product couldn't be developed, and wages and salaries, which is indicative of an overhead cost which normally is one of the three things that are present in every single corporation.

The fact that corporations since that time have been developed to handle all kinds of finance and other kinds of activities, was not of sufficient importance to warrant the legislature of Massachusetts to go far afield in its efforts to discover some formulae which would take care of that particular kind of a corporate set-up. To those of you who are not accountants, the factors are the sales in Massachusetts as the numerator over the denominator of sales wherever made. There are, of course, a great many difficulties as to where is the sale made, and what is a sale, and what constitutes the situs of a sale. The next factor making our formula is tangible property in Massachusetts, and tangible property wherever located, and lastly

wages and salaries in Massachusetts, as to wages and salaries wherever located, constituting a three-headed method which we have found advisable to use even in attributing capital values to Massachusetts for the purpose of taxation, then applying that against the income which is finally brought out as the net income fairly subject to taxation.

It occurs to me that I should be permitted to make this remark: it has always amused me a little bit to know that many people think in terms of the income tax on corporations, or on individuals for that matter, as being something that represents ability to pay. It seems to me that most of our tax terminology is a misnomer, because after all, a corporation paying a tax in 1938 on income earned in 1937 isn't paying taxes out of income, because if they have saved 1937 income to meet their 1938 obligations, they have capital out of which to pay it and not income. If they pay it out of 1938 income which is a tax based on 1937 income earned, it surely isn't income, but we can't find any better word for it and therefore we use that particular word. In the last analysis, we are taxing out of what is available in the current year.

We have found since January 1, 1919, when our law first became effective, up to the present time, pretty close to twenty years, that it has worked with uniform fairness, and while there may be a better formula somewhere, that on the whole is a little better than any that we have adopted.

Let me illustrate one kind of a company. A textile company would have all these elements, and they would work out with fairness in the distribution of the capital. We have such corporations in Massachusetts, as perhaps the Coca-Cola people or the Lydia Pinkham Celery Compound Company that just simply turn a spigot and that is all the capital they need in the form of tangible personal property. Yet that formula works out fairly well in the case of that particular kind of a corporation, and there is reserved the legislative authority given to the tax commissioner that if that formula doesn't work fairly, the corporation can ask for a substitute method of allocation, which can be adopted by the commissioner.

As a tax administrator I am, first, very strongly in favor of some method which will show the way that the tax administrator can work with the taxpayer to reach a result, which will give the taxpayer an opportunity to perhaps anticipate what his tax is going to be in a given state. Second, I want to reserve as a tax administrator the right to handle each individual taxpayer in proportion to his particular needs under a broad authority to bring about a result which after all is going to be fair. And, third, that we don't undertake to imbed too deeply into our statutes or our constitution, if we change it, any formula that Mr. Mattersdorf and the other accountants may work out for us.

CHAIRMAN LELAND: We have at last reached a point in the program, after having found out what accounting is and who accountants are, where we can enjoy the music which was to come here for dinner. Mr. Berry has assured me that for a few minutes it would be worth while before going back to Detroit to listen to the Ford mountaineers.

The buses will not leave for quite some time.

(The meeting thereupon adjourned at nine fifty-five o'clock.)

ELEVENTH SESSION

THURSDAY, OCTOBER 27, 1938, 9:40 A. M.

CHAIRMAN LELAND: The morning session is to be devoted to taxation trends outside of the United States. I have asked my good friend, Commissioner John J. Merrill of New York, to take the gavel for me, and to conduct the session. I think it is quite fitting that New York should be in the chair this morning when this is the topic for discussion.

Mr. Merrill!

JOHN J. MERRILL, presiding.

CHAIRMAN MERRILL: Gentlemen of the conference, I have been coming to these conferences so many years that it seems to be rather a part of my life's work to attend annually. I am delighted to receive this honor at the hands of the president of the association.

First upon the program is "Income Tax Reciprocity with Canada," Mr. Eldon P. King, special deputy commissioner of the Bureau of Internal Revenue, Washington, D. C.

ELDON P. KING (District of Columbia): After preparing this paper and not being very familiar with the objectives of this conference, I had some misgivings over its technical character, but after listening to Dr. Williamson and Dr. Mattersdorf make their reports at the dinner yesterday evening, I can proceed to read this with a great deal more confidence. I think it will probably be regarded as one of the very simple discussions before the meeting.

INCOME TAX RECIPROCITY WITH CANADA

ELDON P. KING
Special Deputy Commissioner,
Bureau of Internal Revenue

I have been asked by your president to submit a few remarks concerning income tax reciprocity with Canada.

The income tax convention between the United States and Canada which became effective on August 13, 1937 seems to present the most current and active topic concerning this subject. It might be noted in passing, however, that there are other instances of reciprocity between the two countries. The instances referred to are the proposals of congress to afford the resident alien a credit for

foreign taxes under certain prescribed conditions of reciprocity (section 222(a) (3), revenue act of 1918), and to exempt from tax certain income of nonresident aliens or foreign corporations derived from the operation of ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States (section 213(b) (8), revenue act of 1921). The same principles have been carried into subsequent legislation. Canada has continued to meet the prescribed conditions but it is believed that the proposals referred to and the Canadian action hold only minor interest for present purposes.

The recent income tax convention between the two countries is an outgrowth of the new plan adopted by congress in the revenue act of 1936 for taxing certain classes of nonresident aliens and foreign corporations. The general plan adopted, with respect to nonresident aliens (section 211(a)) and foreign corporations (section 231(a)) not engaged in trade or business within the United States and not having an office or place of business therein, is to tax such individuals and corporations only on their fixed or determinable annual or periodical gross income received from United States sources. The rate of taxation imposed by that act is 10% in the case of such individuals and 15% in the case of such foreign corporations except as to dividends where rate is 10%. An exception to the general plan is made under which the 10% rate may be reduced to 5% by means of a tax convention with a contiguous country. Pursuant to the latter provision a convention has been concluded with Canada under which the United States rate of 10% has been reduced to 5%. In connection with the general plan of taxation referred to, as well as the convention plan of taxation, it should be noted that the taxes imposed on the fixed or determinable items of income enumerated in sections 211(a) and 231(a) are subject to the withholding provisions of sections 143 and 144 of the revenue act of 1936.

With respect to its operation in Canada, the benefits of the convention are confined to Canadian residents (except United States citizens resident in Canada) and corporations organized under the laws of Canada. If all the recipients of income from United States sources with Canadian addresses had been in fact Canadian residents, or corporations organized under the laws of Canada, the administrative problem would have been relatively simple. It was known, however, that substantial amounts of income would merely pass through conduits in Canada to actual owners outside of Canada. For example, a dividend on stock in a United States corporation might pass to a New York broker (the owner of record as to the corporation) then to a Canadian broker (the owner of record as to the New York broker) and from the Canadian broker to his several customers, one of whom might be a resident in Canada,

another a resident in England, and another a resident in the United States. The same Canadian broker might also receive interest on bonds of a United States corporation which he would pay over to a corporation organized under the laws of Canada. Under the provisions of the convention the resident in England and the resident in the United States would not be entitled to the benefits of the convention. Likewise, the corporation would not be entitled to a reduced rate since as to corporations the benefits of the convention are extended to dividends only.

A solution was sought which, in addition to adequately protecting the revenue, would place a minimum burden on withholding agents, commercial practices and the tax administrative branches of the two governments. This was, in general, accomplished as follows:

The United States regulations promulgated under the convention provide that a United States withholding agent, as the payor of income to a Canadian addressee, is required to look only to the Canadian address. That is, for the purpose of withholding, every individual addressee in Canada (including a nonresident alien individual, fiduciary or partnership) shall be considered by United States withholding agents as a resident of Canada and every corporation whose address is in Canada shall be considered as a corporation organized under the laws of Canada. At this point the assumption is made that the Canadian payee is the actual owner of the property from which the income is derived and consequently liable to the tax on the income. The task of United States withholding agents is thus greatly simplified since they are required to look only to the addresses of their payees.

Under the regulations issued by the Canadian government support is given to the enforcement of this plan in substantially the following manner.

A Canadian addressee receiving income from sources within the United States is required, whether taxable or not, to answer the following questions on the income tax return:

> "Did you receive an income from sources within the United States for or on account of
>
> (a) Yourself ....
> (Yes or No)
>
> (b) Any other person resident in Canada ....
> (Yes or No)
>
> (c) Any other person not resident in Canada ....
> (Yes or No)."

If on filing the appropriate return the questions above are not answered a penalty is imposed and the one in default may in due course be prosecuted for failure to file information required by law.

If (a) is answered "Yes", no further information need be substituted.

If (b) is answered "Yes", the Canadian addressee as nominee or agent for a Canadian resident must file an additional form with the Canadian government appropriate to tracing the income to the eventual owner.

If (c) is answered "Yes", the Canadian addressee as nominee or agent for distribution to or for account of a nonresident of Canada must deduct an additional 5% or 10% as the case may be and remit the sum deducted to the collector of internal revenue at Baltimore, Maryland. He must in addition file with the Canadian government an appropriate form certifying that the additional tax has been deducted and has been or will be remitted to the United States Treasury.

Upon receipt by the United States authorities of the various domestic information returns, duplicates of those involving Canadian addressees are sent to the Canadian authorities. These are sent in the ordinary course of business and without request being made by the Canadian government. The submission of this information to the Canadian authorities affords an appropriate check for those authorities on the answers set forth in the Canadian forms.

The procedure agreed upon avoided many difficulties as affecting both the taxpayers and the administrative branches of the two governments. Without the cooperation referred to proper enforcement of the United States laws would probably have required that United States withholding agents withhold tax at 10% in the first instance on all dividends paid to Canadian addresses. This would have postponed the effective date of the convention for a considerable period since refunds of the excess amounts withheld could not have been made in many instances to those duly entitled to benefits under the convention until sometime after the tax had been withheld. The burden on the Canadian taxpayer incident to the filing of claims for refund in another country and the submission of proof necessary to establish bona fide Canadian residence would have been substantial, as would the burden on the United States tax bureau incident to the examination and handling of these claims.

If, in the procedure established, designed to minimize administrative problems, error is made, the taxpayer concerned still has adequate recourse through the filing of a claim for refund. However, the withholding agents are not, in any important sense, burdened with these claims, which are handled directly with the United States government.

The solution reached well illustrates the possibilities of international cooperation in the field of taxation. Moreover, it tends to remove the basis for the observation sometimes made, that the international taxpayer who deals with two governments has his difficulties increased not twice but many times.

The fact that the administrative practices under the convention may be regarded as somewhat unusual, suggests the desirability of attempting to give them a further setting through at least some brief reference to the development of international tax conventions generally.

The problems incident to the international taxpayer adjusting his taxes with more than one government and the problems of the governments in adjusting their taxes with the international taxpayer have led to the adoption of tax conventions on a rather large scale. Large national debts with accompanying high tax rates and the many instances of failure to give relief from international double taxation have served to accentuate the problems. Illustrative instances of double taxation are those where countries employ different methods in fixing the situs of the property and source of income for taxation purposes; where the countries employ different methods in determining the taxable status of the taxpayer, such as where one country employs the citizenship test and another the residence test with the result that the taxpayer may be doubly taxed through meeting both tests; and where a business enterprise of one country maintaining a permanent establishment in the other finds that due to different rules of income allocation employed by the two countries it is being taxed on more than 100% of its total income. The solution of such problems through tax conventions has not only been of aid to the taxpayers and to the government concerned but has stimulated the flow of trade and commerce.

Prior to 1923 there were few tax conventions but since that year, and particularly during the past decade, they have come into use on a large scale. Counting the conventions of the restricted type, usually involving some single phase of taxation, such as shipping profits, or, as in the case of the Canadian convention, dealing merely with a tax rate, the number now exceeds 140. Of this number, about 45 are of the broader type, many involving the solution of a substantial number of issues.

In the process of affording equitable treatment to the international taxpayer, including, in particular, the elimination of double taxation, many states have insisted that as a part of the process there be included provisions which will safeguard the revenue. The urge in this direction has been quite pronounced during the past few years. The provisions with respect to this phase of conventions may be illustrated as follows: If the states agree on a plan for taxing only once such item of income as royalties, dividends or interest flowing from one state to the other, or of dividing this income between the two states for the purpose of taxation, it seems entirely logical and proper that they should provide for administrative cooperation to the end that the taxing state or states will have complete information concerning the items in question. If the contracting states agree upon, say, the residence theory of taxation,

and a resident in one state receives income from sources within the other it becomes important that the taxing state be furnished information by the state of source with respect to the income involved. Where the business enterprise of one state maintains a permanent establishment in the other state and the two states agree upon rules for equitable allocation of the income, it is but natural and proper that they should insist that the entire accounts be made available to both states. A common provision in tax conventions is that directed at elimination of double taxation or extra-territorial taxes as affecting the parent company situated in one state and the subsidiary company situated in another state. Under this plan an accompanying provision is normally found granting power to each state to rectify accounts where, because of the close relationship, it is found that the companies have not placed their accounts on an arm's length basis. The problem being primarily a factual one, it is but natural that provision should be made so that the accounts will be open to both states.

In the process of eliminating international double taxation, the accompanying plan of safeguarding the revenue comprehends not only the exchange of tax information appropriate to the correct assessment of the tax but mutual cooperation in collection of the tax. This is accomplished by provisions to the effect that one state having a proposed tax bill against a taxpayer whose property is situated in the other state may ask the other state to conserve the property by filing notice of lien or by employment of other appropriate process and, if the claim is terminated in favor of the applying state, that the state to which application is made collect the taxes due and pay them over to the applying state. Provisions to this end are quite common in conventions of the broader type.

In matters of domestic income taxation the states are in a position to employ adequate means (although the means employed may differ) in the assessment and collection of the taxes. In general, the plan in tax conventions of the broader type is to give the states equivalent protection in the international field of taxation.

The growth of tax conventions has been materially aided by the Fiscal Committee of the League of Nations and its similar predecessor committees through the studies by these committees of problems pertaining to the elimination of double taxation and the prevention of fiscal evasion. The fiscal committee during the past two years has been particularly active in its studies of cooperation in the exchange of tax information and in tax enforcement measures. To this end it has gathered and centralized data of much value to countries interested in these subjects. The studies of the fiscal committee are intended to be kept on a practical basis and to this end it has, in the main, selected its members from the tax administrative branches of a number of the leading countries having income tax laws.

Looking at existing tax conventions involving mutual assistance in the exchange of information and in the collection of taxes, it is apparent that the administrative practices developed, as explained above, under the tax convention between the United States and Canada are in harmony with the underlying principles of such conventions and illustrate the desirable results which may be expected to flow from international cooperation in the field of taxation.

CHAIRMAN MERRILL: The next item on the program is, "Contrasts Between American and Canadian Tax Policies." It will be presented by Mr. C. Fraser Elliott, commissioner of income tax, Ottawa, Canada.

C. FRASER ELLIOTT (Ottawa, Canada): Mr. Chairman and Gentlemen, inasmuch as this is my first visit to your meetings, I first wish to express my pleasure in being here. I also should like to express my appreciation of the very excellent papers we have had.

The paper that we have just heard from my friend, Mr. King, was of particular interest to me. He and I just a year ago this month had the pleasure of working together at the fiscal committee of the League of Nations dealing with the very subject which he was dealing with in his paper. So altogether, summing up all these things, I feel at home in this kind of work, I feel at home in this country, and I feel particularly put at home by the kind action of all you people.

CONTRASTS BETWEEN AMERICAN AND CANADIAN TAX POLICIES

C. FRASER ELLIOTT, K.C.

Commissioner of Income Tax for the Dominion of Canada and the Provinces of Manitoba, Ontario and Prince Edward Island

The subject of "Contrasts in Taxation *Policies*" came to my knowledge for the first time when I received the preliminary draft programme.

Servants of the Crown in the British Commonwealth of Nations do not take an active part in public discussion of government policies. They belong to no political party. They are life servants of the Crown to carry out as efficiently as possible policies laid down by the people's elected representatives.

They may guide the formation and practical working out of such policies from within, but they must not publicly criticize them.

These permanent civil servants place the experience and perhaps the wisdom of the near past at the disposal of the immediate party in power. They are the continuing administrative links which maintain the governmental business continuity between successive political administrations.

So my first thought, as a permanent civil servant, was that the invitation to speak on matters pertaining to policy must be declined.

Such a thought brings out the first contrast between our respective administrations, namely that civil servants in Canada remain at their posts for life. They do not discuss public policy in a public sense. On the other hand, the principal or senior civil servants of the federal and state governments, I understand, do discuss public policy in a public way and remain in their post only so long as their party remains in power.

However, I shall not discuss current policies but rather respective factual determinations of the immediate past. That is, prior policies that have been adopted and are now in force as permanent features in our respective governments.

This does not involve praising, condemning or impartially explaining presently conflicting policies which are striving for ascendency within our countries. Therefore those representing such interests will not be offended.

Whoever assigned this subject to me made an error which was flattering in its presumption. He presumed that I knew, or do now know, your taxation laws, all of them, and as well the relative Canadian tax laws. Every day in my own country my fellow-citizens tell me that I don't even know the few income tax laws I am endeavouring to administer. Mr. Helvering knows as well as I do that only too often they are right.

So between a few generalities and a profound silence on much of the subject I may be able to continue the great illusion.

Alice in all her wonderland never had such a "bother" as we in our taxation maze. Considering each of the many jurisdictions with their different powers and other forms of imposition than ours, what know we more confounding than the existing maze of tax laws? However, as Alice in her simple way said, "Begin at the beginning and keep right on," so shall I, even though I speak perhaps as a Mad Hatter in a mad house.

To begin, yours is a written constitution and all laws are strictly limited thereby.

Our constitution is partly found in a statute passed by the Imperial Parliament of Great Britain, though it was prepared and drafted in Canada. Like yours, it also is a written constitution. In legal concept our constitution can be changed by the Imperial or now British Parliament. What that parliament has enacted it can repeal or amend. However, constitutional practice has circumscribed any such right, has precluded any such action and has reduced it to a mere fiction.

Does this not indicate a contrast, latent in our respective constitutional laws?

For example, constitutionally you are precluded, I understand, from taxing salaries of state servants or income from state bonds,

though recent developments in your supreme court may indicate some doubt on this point.

Constitutionally we suffer no such limitation in imposing, as a policy, federal tax on income arising out of state or provincial contracts.

As our respective constitutions are written, how does it come that Canada has power, and particularly the power of taxation, beyond and apart from the written instrument, which you on your part possibly have not?

Are the federal and state powers so circumscribed by the written constitution that they each lack the power to tax revenues emanating from any one of the others?

Let me indicate the answer to the first of the above questions. You know the answer to the second better than I do. My answer may afford an interesting contrast.

Constitutional Rights—Apart from the Written Instrument

The following quotations indicate the development of our constitutional rights quite apart from the powers, and the division of powers, between the Dominion and provincial jurisdictions as contained in the British North America Act, referred to as our written constitution.

The Honourable Mr. Justice Burbidge, speaking in *Algoma Central Railway* v. *the King* (decided in 1901), 7 Exchequer Court Reports, 239 @ 253:

> "As long ago as 1778 it was declared by an act of the Imperial Parliament that thereafter the King and Parliament of Great Britain would not impose any duty, tax or assessment whatever, payable in any of His Majesty's colonies in North America or the West Indies. And the policy of the Imperial Government has been to leave the self-governing colonies free and uncontrolled in matters relating to taxation within such colonies respectively.
>
> They would, no doubt, receive with surprise and impatience any intimation of the passing of an act by the Imperial Parliament to levy taxes in Canada, no matter how unobjectionable otherwise the provisions of the act might be. Such an act according to its provisions would be regarded as an unwarranted interference with the freedom and authority of the parliament of Canada or of the legislatures of the several provinces of the Dominion. Happily no such thing is possible, but the practical independence of the parliament of Canada and of the provincial legislatures in that respect rests on no unalterable convention or statute but *upon the wisdom* of those who control the destinies of the Empire. In reality the power of the Imperial Parliament is as great and its supremacy as absolute

over the subject of taxation within Canada as it is over any other subject committed by the British North America Act, 1867, to the parliament of Canada or to the provincial legislatures. The right of the Dominion Parliament and of the provincial legislatures to legislate freely and without control, other than that defined in that act, does not depend on the absence of any supreme or sovereign authority, but in the knowledge and understanding, which has come, in the course of events, to be accepted as part of our constitution, that the sovereign authority will not exercise its undoubted powers unsolicited, or against their wishes."

Later, as Sir Robert Borden pointed out—

> "With the material growth and constitutional development of the oversea nations the parliament of the United Kingdom has ceased to be an imperial parliament in any real sense so far as the dominions are concerned. Its legal power is subject to the limitations of constitutional right. Theoretically it has power to impose direct taxation upon the people of any dominion. Constitutionally and practically it possesses no such right or authority. The exercise of any power contrary to established or developed conventions would have legal sanction, but would not be respected, and in the end could not be enforced. In practice the position is becoming tolerably clear; in theory there remains a singular anomaly."

So much is said in respect of the development of the unwritten part of the Canadian constitution to show the contrast with your written constitution, which I understand is wholly self-contained while ours though originating in an imperial statute has by constitutional development and understanding brought the full sovereign rights, powers and privileges of a king and his kingdom within the ambit of Canadian constitutional authority. Canada now exercises all rights and assumes all obligations, internal and external, as fully and as effectively as the British Crown, in the plenitude of its power, could exercise.

All this has been confirmed in the agreement (1926 and 1930) known as the Statute of Westminster, wherein among other things it is enunciated that the crown is the symbol of the free association of the commonwealth of nations to which they owe allegiance and it confirms the right of each dominion to make domestic and extra-territorial laws as wholly independent sovereign powers.

It follows therefore that the king, by and with the consent of the Canadian Parliament, can impose in Canada upon his subjects for Canadian purposes any form of tax, not because of any written authority but by constitutional right.

The written division of taxing powers between the Dominion and provinicial jurisdictions contained in the British North America Act is the division of an existing constitutional right to impose taxes, controlled, however, by the necessary consent of the respective Canadian legislative bodies.

As a result of this power, dominion and provincial taxes are imposed on federal and provincial civil servants. There is not any constitutional limitation, only a limitation of reason, i. e. there must not be discriminatory taxation by the federal authority on the salary of provinical civil servants, judges or provincial legislative members. Taxes must be uniformly imposed on all persons having equal incomes at an indiscriminatory rate. Thus the power to tax, as a power of destruction, is substantially eliminated.

The provinces likewise can tax the members of the Dominion Parliament and senators on their salaries and indemnities and also dominion civil servants on their salaries, provided there is not any discrimination. Such a uniform imposition is not calculated to abrogate the capacity, derogate from the status, or imperil the finances of those serving the state, whether paid from dominion or provincial public funds.

In the respective jurisdictions, dominion and provincial, each sovereign in their own right, lies the constitutional power and right to impose such a tax.

The tax is imposed because there is a receipt of income, from whatever source derived, i. e., without having regard to the source.

Immunity from tax cannot be secured in Canada by giving services to the state in any capacity.

I understand the United States federal and state authorities have not power to impose income tax on state servants in respect of their salaries, indemnities or other forms of remuneration paid out of public funds, including interest paid therefrom to anyone.

This occasions the further contrast, i. e. by taxing remunerations and interest paid from public funds we perhaps adhere more uniformly to the principle of "ability to pay."

Our Respective Written Constitutions Allocate General and Certain Taxation Powers

Under our constitution general powers not given the provinces remain with the Dominion, i. e. the residuum of power lies with the Dominion.

In your case, I understand, it is the other way around, what has not been specifically given or delegated to the federal remains with the state.

These are important differences and account in some measure for some of the existing contrasts in our respective national affairs.

Re Allocation of Direct and Indirect Taxation Powers

In our case the provinces are limited to the imposition of direct taxation within the province for provincial purposes. They cannot constitutionally impose indirect taxation. This is a very important limitation.

On the other hand, the Dominion can impose any form of taxation, direct or indirect.

In your case I understand there is no limitation of the kind of tax which may be imposed by the state authorities and few limitations upon the federal.

As a result, constitutionally in Canada there cannot be any sales tax imposed by any province in the form of an indirect tax.

In your country I understand sales tax is in force in various states.

Re Co-operative Single Administration for Multiple Jurisdictions

Income taxes in Canada can be and are imposed by provincial and dominion authority. In fact, six out of nine provinces impose income tax, as well as the Dominion.

Likewise in the United States, income taxes are imposed by both federal and state authorities. In this, the field of direct taxation, there is similarity between us, not contrast.

The Dominion of Canada, by agreement with three of the provinces, administers its own and as well the provincial income tax laws. Thus we have one return to one administration, one tax and one statement of the tax payable to satisfy dual jurisdictions. The collections are received by one dominion authority for all jurisdictions, and redistributed to them. There is but one form on which to supply "information from the source" to one one dominion government. The results are eminently satisfactory to all concerned.

In such co-operative procedure lies a hope for some future measure of extended simplicity.

I understand the federal have no such working arrangement or agreement with any of the states.

Re Federal Courts

The Dominion has one itinerant federal court, the Exchequer Court of Canada, to which all tax appeals are referred, thus insuring uniformity in the application across Canada of any decision and likewise a satisfactory continuity of developing jurisprudence.

I understand your appeals do not get to a nation-wide tribunal until they reach the supreme court of the United States, excluding of course administrative appeal boards.

Re Regulations

Our regulations are substantially confined to those required by statute. We do not publish so-called rulings on cases departmentally decided.

We do not attempt before the event to expand or interpret the law by general rulings and regulations. Thus we are not embarrassed by interpreting the interpretations in the light of after-the-event facts, nor of differentiating between a present case and several previously decided by the department. It is indeed rare when the facts in one contentious case are exactly on all fours with another contentious case.

I understand you issue many rulings and regulations with a view to facilitating the taxpayer and his advisers. The statute is of course fundamental and the regulations may be voluminous. Does it make for simplicity or is there more language to interpret and therefore more room for confusion? I do not know, not having had experience with your system, but I can say ours seems to work satisfactorily.

Re Taxation of Capital Gains and Loss Combined with Income vs. Taxation of Income only under one Act

You tax *capital gains* under an income tax measure. We do not. Our view has been to keep an income tax measure confined to income as that word is generally understood and legally interpreted. Should we tax capital gains I am sure it would be done under a separate act.

In contrast, the result of our respective policies, i. e. one a pure income tax measure and the other a combination of income and capital gains and losses measure, is rather interesting.

In the United States in a period of rising security prices and large profits on the market, so called income tax revenue soar but in a period of general declining prices the reverse is true and revenues shrink. In other words, there are large fluctuations and considerable instability in the revenue from the income tax law.

For example, the revenue from income tax in the United States between 1930 and 1933 went down from $2,402,000,000 to $746,000,000, a reduction of over two-thirds, even though the rates were increased, while in Great Britain and Canada a relative condition of stability obtained.

These are important results particularly for those charged with estimating budget receipts for the ensuing year.

Re Graduated Corporation Rates and Forced Annual Surplus Distributions

In Canada we have a flat corporation rate of tax. In England they maintain that they have no corporation rate of tax, while in the United States, I understand, there is quite a movement for

graduated rates of corporation tax, if not in the first instance, then in the second in respect of the undistributed profits of corporations.

On this latter question we in Canada feel that a statutory direction to be annually applied indiscriminately in all cases where profits are not distributed is perhaps not the best method. As we now have it, each case is reviewed in the light of the character of the business and its need for an accumulated surplus and the extent to which that surplus is actually used in the business to earn the income is determined. This is not an annual affair. An examination is instituted only if it initially appears that the surplus is excessive.

If the company can show good reason for non-distribution no tax is imposed, if not, and the accumulated surplus is beyond the requirements of the business, then an appropriate part of the surplus is deemed to be distributed as a dividend and taxed accordingly.

It is a question of a distribution ordered for cause, versus distribution by annual statutory direction on a fixed basis for all concerned, irrespective of the kind of business or the need for surplus assets.

Re Amendments

As to amendments—we enacted our law in 1917. We still have the same statute in its essential features, though considerably altered on the mechanical and procedural side. The British act has been dealt with in the same manner.

The process of frequent amendment in the light of actual experience in bolstering up the principle of the law is thought to be advisable, though amendments by whatever method employed are always the subject of complaint. It is a question of two evils.

The Canadian process of frequent amendment has already occasioned such appropriate amendments that the schemes referred to by the president of the United States in his recent message to congress could not have been successfully carried out in Canada.

We examined the tax-dodging schemes referred to by him and, while some of them are not applicable because of the capital gains feature in your law, on the income tax side we had already anticipated such methods of evasion.

Speaking further on the general question of amendments, it can be said that one of the most important amendments we made in principle was a very simple one. It was designed to keep the act purely an income tax measure, i. e. in determining "income" there would be allowed as deductions only those expenses that were wholly, exclusively and necessarily laid out or expended for the purpose of earning the income and then further, no deduction for any outlay, loss or expenditure on account of capital.

In your country, I understand, since 1916 some ten or more complete revenue acts have been passed. This may be similar in purpose to our method of amendments, but I doubt it. The succes-

sive acts do more than just bolster up the principles of income tax. They introduce entirely new features, some of which may or may not be entirely germain to the securing of revenue only.

Whether greater confusion than is otherwise expected in tax matters is occasioned by these many acts is a matter of opinion. I merely point out our different methods of amending and expanding the income tax laws.

Re Separate State Departments, one to create and the other to interpret and administer

There are more contrasts but I shall not pursue them further other than to state that Canada, it seems, is the only country in the world which entrusts the collection of its revenue to a separate department of state. In Great Britain, in the United States and elsewhere there are finance or treasury departments, variously named, which are concerned with both the imposition and the collection of taxes, but in Canada we have two departments, the department of finance and the department of national revenue, one procuring the imposition of taxes and thereby putting the tax policy into force by way of legislation, and the other carrying on the collection of federal taxes as an interpretative and administrative matter.

Our Fundamental Similarities in Citizenship

Frequently it happens that indicated contrasts are only a means of showing similarities. Our people have many characteristics in common. I should like to close this paper of contrasts on a note of similarity. The basic one to my mind is a similar personnel and a like ideal of citizenship. The laws are only what the citizens would have them be.

The present generation has every reason to be aware how great and precious a thing our common citizenship is. Within our memory man gave his all in a cause common to our respective countries. They gave their very lives to secure our heritage. Against the background of such sacrifice it must appear contemptible to all honourable men that any citizen should consider it a clever thing to evade just payment of any taxes required by the nation. Men who are quick to declare pride in their country and at the same time slow and reluctant to do their duty to their country, have little right to national or international neighbourly privileges.

It was personal and national character that built what we now have. It will be not less than that which will lead us out of our present difficulties. We, on this continent, belong to a people which has never been beaten by circumstance. These moral qualities still abide in the people of North America.

Indeed, the reputation of any nation established through good citizenship is more to be desired than through material things. The

greatness of a nation in territory may be measured; the finances and revenues may come under accurate computation; the population may be numbered and all these things tabulated by cards, and reflected on charts and maps, but there is nothing in national affairs more subject to error than the right valuation and true worth concerning the power and force of good citizenship. The earth may be compassed but not man. The kingdoms of the world may be measured and tabulated but all the king's horses and all the king's men have neither wit nor wisdom to measure the good citizen within the gates.

In the light of the vivid past and the present great issues, tax laws should not be considered in the nature of penalties, but as a vital factor in the needs of the nation.

If the citizen can have a greater understanding of the reason for, and the terms of, the various tax laws, and thereby the better adjust his attitude toward them, then that understanding and that attitude will lighten at least the mental if not the monetary burden.

Mr. Elliott: By permission, I have one thing to add. As I stated in the beginning, I thoroughly enjoyed the conference and I am greatly impressed with the good work that it does. I made the suggestion to your president that perhaps it would be an appropriate time when taxes are a matter of so great concern, to suggest that we might expand this fine organization internationally. I only throw out the suggestion to say that in so far as my efforts can be of aid in doing that, I shall be very happy to lend them.

Chairman Merrill: The next item of the program is, "Significant Tax Legislation in Foreign Countries," Mr. Gerhard Colm, of the New School for Social Research, New York City.

SIGNIFICANT TAX LEGISLATION IN FOREIGN COUNTRIES

GERHARD COLM
New School for Social Research

I feel almost at a loss in face of the task to report to you on significant tax legislation in foreign countries in the time which has been allotted to be my our president. It would be a hard job to deal with recent tax legislation in any one of the greater countries such as Great Britain, France of Germany within this time. There is now in each country more significant tax legislation enacted during one year than there used to be during a decade. To fulfill the task assigned to me, I must try to find out whether something like a trend can be observed in foreign tax legislation. Only by making a few general statements concerning the development in a number of countries at once can I hope to cover my topic. But

perhaps the various countries were not considerate enough to conform to such a general trend in order to facilitate the task of a student of taxation. There is certainly the danger involved in all generalizations lest we construe a trend where actually perhaps anarchy prevails. Therefore I must warn you from the outset that the sweeping statements which I am compelled to make need elaboration and qualification in many respects. Yet I shall dare to present such generalizations to you because it enables me to fulfill my task and it will certainly enable my critics to fulfill their task.

I.

Yet one general statement concerning the trend in tax legislation in all countries can safely be made. Taxes become bigger and worse every year. The first part of this statement which says that taxes become higher and higher needs little elaboration and will be challenged by nobody. Taxes hardly reached 10 per cent of the national income in any of the greater countries before the world war. They surpass 20 per cent in most countries at the present time.[1] The second part of my statement, however, can be questioned. The answer to the question whether it is true that taxes became worse depends, of course, on one's opinion of what good taxes are (if that is not regarded as a contradiction in itself). Good taxes usually are described as taxes corresponding to the ability-to-pay principle, which are fiscally productive and interfere as little as possible with the economic process as it would be without taxes (the principle of economic neutrality). According to the best teachings of the science of taxation the progressive individual income tax corresponds more than any other tax to these criteria of a good tax. It has often been described as significant for the modern trend in taxation that the proportion of *ad rem* taxes in the whole tax system diminished and that the share of subjective taxes, especially of the income taxes, increased. This trend has been considered to be an improvement of the tax system.

It seems to me that there is a trend away from ability-to-pay taxation observable in recent years. This statement seems to contradict the fact that the number of countries which have an individual income tax on their statute books has become greater from year to year and that there are today probably not more than five countries of importance in the world[2] which do not levy a progressive income tax. Before the world war thirteen countries had an individual progressive income tax, during the world war eight

[1] For recent years based on *Tax Systems of the World*, 7th. ed. 1938; for former years based on estimates of the author.

[2] Cf. *Tax Systems of the World*, 7th ed., p. 362, enumerates the Dominican Republic, Honduras, Nicaragua, Uruguay and Venezuela as the only countries which have not enacted income tax legislation.

countries enacted such a tax. Immediately after the world war, in the years between 1919 and 1924, forty-three countries enacted an income tax. Later seventeen countries followed. The financial needs of the depression again induced some four of the last countries which lagged behind the general trend to follow suit.

TABLE 1

NUMBER OF COUNTRIES THAT HAVE ENACTED INCOME AND SALES TAX LEGISLATION

Countries that have enacted income and sales tax legislation	Income taxes	Sales taxes
before 1914	13	2
from 1914 to 1918	8	3
from 1919 to 1924	43	26
from 1925 to 1930	13	3
from 1930 to 1938	4	7
Countries with income and sales taxes in force at the present time	80 (1)	37 (2)

(1) Austria lost her autonomy in 1938, hence she is not included in this figure.

(2) Portugal and Greece abolished sales taxes; Ethiopia and Austria which had general sales taxes lost their status as autonomous states. Sales taxes in the states of the United States are not taken into account.

Yet this spreading of progressive income taxation all over the world did not result in a correspondingly increasing weight of income taxation in the whole tax revenue. Especially in those countries which enacted income taxes relatively early, this tax source did not increase as much as other tax sources did. In the second table the percentage of income tax revenue in the whole tax revenue is calculated for thirty-five countries. In ten countries for which comparable figures are available, we find that the percentage increased from the pre-war to the post-war period, comparing 1913/14 with 1928/29, while it decreased in two countries (Hungary and Germany). Comparing, however, the figures for 1928/29 with the most recent data for 1935/36[3] we see the percentage increased for fourteen countries but decreased in sixteen cases. Finding fourteen countries with an increasing, sixteen countries with a decreasing importance of income tax revenue does not seem to indicate a very startling trend. Yet this result appears more significant if we see what countries are among those sixteen countries with a decreasing ratio of revenue derived from income taxation. Among these latter cases is the majority of the larger countries and most of those which already had an income tax enacted before the war. The recent figures may in some cases still be under the influence of the

[3] Compare footnote to Table 2.

depression and income taxes are more susceptible to the depression than other tax revenues. It is quite possible, and probable also, that in a few countries a still further increase of the share of income taxes in the whole tax system can be expected. On the other hand, in most cases it was not possible to eliminate the returns from corporate income taxes from our statistics. For the individual income taxes alone the results would show a clearer trend.

TABLE 2 *

CHANGES IN THE RATIO OF INCOME TAX TO TOTAL TAX REVENUE

Changes in the ratio of income tax to total revenue from 1913/14 to 1928/1929

(ratio of income tax to total tax revenue in 1913/14 equal unity)

Finland	1050%	Austria	31%
United States	800%	Norway	31%
Japan	222%	Sweden	30%
Netherlands	112%	Spain	27%
Italy	62%	Germany	—24%
Great Britain	54%	Hungary	—33%
Denmark	38%		

Changes in the ratio of income tax to total tax revenue from 1928/29 to 1935/37

(ratio of income tax to total tax revenue in 1928/29 equal unity)

Iraq	775%	Luxemburg	—
Latvia	112%	Finland	— 4%
Canada	73%	Spain	— 5%
Mexico	57%	Denmark	— 6%
Lithuania	50%	France	— 7%
Greece	25%	Great Britain	— 7%
South Africa	23%	Germany	— 8%
Estonia	20%	Norway	— 8%
Hungary	17%	Czechoslovakia	—15%
New Zealand	17%	Belgium	—17%
Haiti	11%	Australia	—18%
Bulgaria	10%	Rumania	—18%
Japan	7%	Sweden	—19%
Switzerland	0.3%	Poland	—21%
British India	—	Netherlands	—29%
Ireland	—	United States	—37%
Italy	—	Austria	—44%

* Based on the data of Table 2—Appendix (p. 534).

The figures seem to indicate, therefore, that income taxation is approaching its climax or may have passed its climax already in quite a number of countries. Thus we must ask whether perhaps the triumph of the income tax principle coincides with the beginning of a relative decline in its practical importance.

Other types of taxes were developed and strengthened at the same time and often brought a greater increase in revenue. Among these other taxes the greatest rôle was played by automobile taxation in its various forms, the general sales tax and the corporate income tax. There is little to say about the growing importance of automobile and gasoline taxation. It is a type of taxation complying with the benefit rather than with the ability-to-pay principle but it is tolerated even by the most ardent defenders of ability-to-pay taxation. Its growth is considered more the result of the increasing importance of the automobile than the result of a change in tax policy.

The sales tax is the typical post-war tax. Before the war there were only two countries which had a general sales tax; three countries introduced such a tax during the war. But in the financing of the aftermath of the war the sales tax became almost a general feature of the tax system. During the years 1919-1924, twenty-six countries introduced a sales tax. Seven countries enacted such a tax during and after the world depression (*cf.* table 1). In some countries it became the most productive tax and its revenue surpassed the yield from the income tax, for instance in France, Czechoslovakia and Germany. The turn-over tax furnishes over four-fifths of the total revenue of the unified budget of the Soviet Union. Quite a number of countries, like Canada, Italy and Australia, which already had a sales tax, increased the rates during the great depression. In the states of the American union the sales tax became one of the main sources of depression financing.

Although the corporate income tax shares its name with the progressive individual income tax, it means something entirely different. Its expansion has less to do with a consequent application of the ability-to-pay principle than with using incorporated business as a very productive source of revenue. Taxation of corporations in the form of excess profits taxes was a significant part of war finance. Corporation taxes also became a significant feature of rearmament finance. Rearmament brought such an improvement of business conditions that a high tax on profits seemed to be justified. Germany raised the corporate income tax from 20% to 35% and will collect 40% of the profits from larger corporations beginning with the coming year. This is the only important tax measure enacted in the course of armament financing in Germany. Also Great Britain's National Defense Contribution includes a 5% tax on corporate profits. This marks a very significant departure from the British tradition. France attempted to increase her revenue by a multitude of small measures. The most significant steps were the attempt to

make the individual income tax more effective, to simplify the administration of the sales tax and to introduce a 4% tax on undistributed profits.

Very interesting is the Italian extraordinary company levy of 1937. All Italian corporations must pay 10% of their capital and reserves or 5% (in some cases 2.5%) if they are in the red. Half of the tax can be paid in shares which the corporations must repurchase from the government from profits of later years. Corporations which consigned shares to the government must place a government trustee on their board of directors. This tax, too, is in effect a tax on corporate profits.

Also in a few other countries experiments are being made to combine corporate profit and capital taxation with the intention of extracting at least some money from corporations which make little profit or operate at a loss. The Swiss Crisis Tax is of this type and in South American countries a similar attempt has also been made.

Thus it appears to me as a significant development that, on the one hand, those countries which are still lagging behind in progressive income taxation try to develop this most respectable among all taxes and try to refine its administration. Yet the yield of individual income taxes could not be increased as much as the expanding governmental functions, as war and war preparation required. Tax legislators got little aid from science in their search for new sources of tax revenue. They took the money where they found it, especially from business. Business was taxed on the basis of sales, of profits, of capital and of payrolls. All this without any system, without principles, without guidance or help from theory. Science in the meantime was weeping over the tax legislators who neglected the ability-to-pay principle. Income taxation, too, was once introduced as an emergency measure against the opinion of theorists and it took some time before it was discovered to be the ideal tax. I think it will take a little while before the science of taxation will discover that business taxation certainly is not the ideal form of taxation but may have certain merits if it is systematically developed and then may have its proper place in a modern tax system.

So much for the application of the ability-to-pay principle. But public finance sets up another criterion of a good tax, the principle of economic neutrality. A survey of recent tax legislation in foreign countries shows also that this criterion, too, is no longer respected by many tax legislators. In many countries tax policy has been used (or misused, if you wish) as a means of social or economic policy. For this purpose not only taxes but especially tax exemptions have been applied. Several countries grant subsidies to specific industries in the form of tax exemption. It has been estimated that Great Britain relieved her agriculture through "derating" by some £15 million a year. Germany and Italy granted tax

exemption for new motor vehicles in order to stimulate this line of production. Italy exempted new factories from income taxes in specific regions of the country. Germany and France exempted, temporarily, investments in new machinery and premature replacement of machinery from income taxes. In Germany this privilege was cancelled as soon as the industry was operating at full capacity. The construction and modernization of houses was stimulated by tax privileges in France, Germany and Italy. Canada exempts mines for an initial period of operation. Italy has tax advantages designed for attracting foreign capital, for inducing the purchase of new stocks and for stimulating colonial enterprises. In the British income tax and defense contribution certain exemptions in the interest of the rationalization of industry and for stimulating industrial development of distressed areas are provided. In the one case the board of trade, in the other special commissions for various areas must certify the merit of a case.

To these tax incentives, on the one hand, correspond penalty taxes on the other. Chain store taxes are applied in a number of countries like France, Germany and Canada. Other countries impose a special tax on large retailers. Czechoslovakia has a special tax on selling through cartels.

It seems to be quite natural that Russia used her sales tax in the most far-reaching way as a means of planning. Through the sales tax the profits of state and cooperative enterprises are partly absorbed. Since various branches of industry differ in profitability the tax rates differ from industry to industry. There are applied 2400 different sales tax rates.[4] The sales tax therefore is used as a device to equalize to a certain extent the profitability of various industries, and to leave extraordinary profits in the hands of an industry only if an extraordinary extension of this specific industry is intended according to the five-year plan. Otherwise these profits are absorbed through the tax and used for financing the budget.

There has been much discussion of the special tax advantages for large families and the penalty taxes for bachelors or for couples without children enacted in various countries. In Germany taxation has been used also as a device for her racial policy. Deductions for dependents from income taxes are not permitted there for Jewish children. It is impossible to analyze at the present time how effective these various measures of incentive or penalty taxation may have been. Without offering any proof I would suggest that the measures which were designed to bring about recovery were mostly of secondary importance only. If market conditions are so bad that entrepreneurs do not invest in new factories and new equipment, then they can hardly be induced to invest because of a tax advantage.

[4] *Cf.* P. Haensel, "Public Finance of the Union of Soviet Socialist Republics," in *The Tax Magazine*, October 1938, p. 591.

Only when other measures of a recovery policy, like government investments, were enacted at the same time, then such tax incentives were successful in supporting and strengthening recovery.

Tax incentives designed to induce not enterpreneurs but private individuals to buy a motor car or to modernize a house probably were most effective.

Yet I do not overrate the importance of all these measures. They are significant, however, because they indicate a change in the attitude of tax legislators. If I may try again to formulate a generalization, I would say that the classical request for economic neutrality in taxation has been replaced partly by the demand for a tax policy which is consistent with the general aims of economic and social policy. Also this tendency follows quite logically from our first observation, regarding the general increase in tax levels. Taxes reached a mark where their effects necessarily became a factor shaping economic and social development, whether such an influence was intended or not. There are no neutral taxes any longer. If this fact becomes apparent, it is quite natural that tax legislators conceive measures the effects of which are in accordance rather than conflicting with the general aims of policy.

Yet I do not wish to be misunderstood. If we study recent tax legislation in foreign countries, we do not find that the tax legislators were consciously aiming at a tax system adjusted to the requirements of economic and social policy. The measures of incentive and penalty taxation which we described before consisted in rather superficial modifications of taxes which originally were enacted without concern for economic necessities. These modifications have only a limited effect and they may impair tax morale. Yet it appears likely to me that these superficial practices are, so to speak, forerunners of a more fundamental concern for economic and social necessities in the development of the whole tax system.

We started by saying that taxes became bigger and worse and we found that with the increase in the tax level the traditional criteria for deciding whether taxes are good or bad became questionable. Thus only the first part of our statement can be maintained.

We have reached a situation in which a wide gulf separates practical tax legislation and administration, on the one hand, and the class-room teachings of the traditional principles of taxation, on the other hand. This in itself appears to me one of the most significant and critical features of our whole tax situation. Such a situation presents a challenge to tax legislation as well as to the science of taxation. If I understand correctly the aims of the National Tax Association and of these annual meetings, they are designed to bridge this gulf between the practice and the science of taxation and will fulfill a vital function in such a critical situation. I thank you for giving me the opportunity to cooperate with you in this task.

TABLE 2—APPENDIX

INCOME TAXES OF VARIOUS COUNTRIES IN PERCENT OF TOTAL TAX REVENUE [1]

Country	Budget year covered [2]			Income taxes in percent of total tax revenue		
	1913/14	1928/29	1935/37	1913/14	1928/29	1935/37
I. Countries that enacted income tax before 1914						
Finland [6]	1914	1929	1935/36	2	23	22
United States [3, 9]	1913	1928	1937	3	27	17
Netherlands	1913	1929	1936	8	17	12
Hungary	1913	1928/29	1935/36	9	6	7
Japan	1913	1928/29	1935/36	9	29	31
Denmark	1913/14	1928/29	1935/36	13	18	17
Spain	1913	1929	1935	15	19	18
Italy [7]	1913	1928/29	1935/36	16	26	26
Norway [6]	1913/14	1928/29	1935/36	19	25	23
Sweden [6]	1913	1928/29	1935/36	20	26	21
Great Britain	1913/14	1928/29	1935/36	28	43	40
Germany [3, 5]	1913/14	1928/29	1935/36	34	26	24
Austria [3]	1913	1929	1935	11	16	9
II. Countries that enacted income tax 1914 to 1918						
France [3]		1928	1936		7.1	6.6
Canada		1928/29	1935/36		15	26
Australia		1928/29	1935/36		17	14
New Zealand		1928/29	1935/36		18	21
III. Countries that enacted income tax 1919 to 1924						
Latvia		1928/29	1935/36		2.5	5.3
Lithuania		1929	1935		4	6
Estonia		1928/29	1935/36		5	6
Switzerland [8]		1928	1935		6	6.2
Bulgaria [3]		1928/29	1935		6.7	7.4
Greece		1928/29	1935/36		8	10
Haiti		1928/29	1935/36		9	10
Czechoslovakia		1929	1935		13	11
Poland		1928/29	1935/36		14	11
Luxemburg		1929	1936		17	17
British India		1928/29	1935/36		21	21
Ireland [3, 6]		1928/29	1935/36		21	21
Belgium		1929	1936		30 [4]	25
Rumania		1929	1935/36		34	28

TABLE 2—Appendix—*Continued*

Country	Budget year covered [2]			Income taxes in percent of total tax revenue		
	1913/14	1928/29	1935/37	1913/14	1928/29	1935/37
IV. Countries that enacted income tax 1925 to 1929						
Iraq		1928/29	1935/36		0.8	7
Mexico		1929	1935		7	11
South Afric. Union		1928/29	1935/36		22	27
V. Countries that enacted income tax 1930 to 1938						
Siam			1933/34			
Argentina			1934			

Explanatory Notes to Table 2

[1] The figures given refer in the majority of cases to taxes collected by the central governments only; in almost all cases sur- and super-taxes as well as corporation taxes are included in the income tax revenue figures. Exceptions are indicated by the following notes.

[2] The figures for 1935/36 or 1936/37 are mostly estimates or provisional in nature.

[3] Corporation taxes excluded from income tax.

[4] Including National Crisis Contribution.

[5] Covering Reich, states and municipalities.

[6] Income tax figures include property tax.

[7] Income tax figures include the tax on bachelors.

[8] Income taxes embrace military tax, yield of war tax, and for the year 1935, also emergency tax on income and property.

[9] Covering federal and state taxes.

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Chairman Merrill: Now, gentlemen, we have reached the point where these papers are to be open for discussion, and Dr. Harley L. Lutz, professor of public finance at Princeton University, is requested to open the discussion.

Harley L. Lutz (New Jersey): Mr. Chairman, Ladies and Gentlemen: It is obviously impossible for me to discuss all of these

excellent and interesting papers, but Mr. King dealt with some technical and administrative problems which others would be more competent than I to consider, and I pass over his paper therefore.

Mr. Elliott told me that he was quite willing that there be certain small errors in his paper just for seasoning if for no other reason. I think it was a very interesting and an excellent discussion of the contrasts and similarities between Canadian and American tax practice.

He did say, however, that the states have complete freedom to levy taxes. Under the constitution, the one important limitation upon the states' power to tax is that they may not impose import duties. But, as a matter of fact, the use tax is getting pretty close after that restriction and may be the opening wedge for its complete informational amendment.

He also stated that the federal government may not tax the salaries of state servants. That has recently been brought into question by a decision of the supreme court which we could not expect Mr. Elliott to follow, because of the fact that the decision has been given only recently. He was quite correct, however, in implying that federal salaries still enjoy and apparently will continue to enjoy 100 per cent immunity from any state taxation.

Partly because of the subject matter, and also because Professor Colm was able to supply me with a copy of his paper some days ago, I have therefore restricted such comment as I shall make to certain points in his discussion.

He pointed out that there is one safe trend, taxes are getting bigger and worse every year. I was interested in his test of "worseness". He began by citing the spread of progressive taxation, and the income tax as the best expression of progressive taxation, as the indication of goodness in a tax system.

Of course, in this he is, as he admitted, following the classical line of thought and of teaching, that insofar as it is humanly possible we should make our tax system progressive.

While many countries introduced progressive income taxes in the last thirty years, he suggests that we have evidence of a trend away from this standard of goodness by virtue of the fact that there is a declining relative importance for the income tax. Of course, we might cavil a bit at his use of the idea of a trend there. Naturally, he did not imply that countries are abandoning the income tax, but rather that they appear to have exhausted its fiscal possibilities and are therefore obliged to resort to other types of taxation. They are building up revenues from those other sources to a point which does make apparent a trend away from the fiscal importance at any rate of income taxes.

One of the principal alternative measures which he emphasized is the sales tax in some form. I think we should interpret this situation. I venture to interpret it in a manner somewhat different from

that which Professor Colm has undertaken. Of course, as he pointed out, the trend from so-called good to bad or undesirable taxation has been caused by inordinate spending, and we needn't devote any time to an elaboration of that point. But it was forced upon our government and other governments by a fact which Professor Colm has adequately recognized, mainly, the fiscal inadequacy of income taxation.

That is pretty clearly established. While it is true theoretically that taxes are paid from income, it is obviously a practical impossibility to get all of the tax revenue you want by means of a tax on income of the sort that we ordinarily use.

But the question of the extreme superiority of progressive income taxation deserves more careful consideration than it has received.

Income tax policy here and elsewhere has developed along the line that the greater the progression the closer the approximation to ability. In the United States, as you know, we have defended every increase of rate and every expression of the progression by an appeal to ability. We must tax according to ability, we must increase the progression, we must extend the rate, we must do this and that, all because we are getting closer to this theoretical standard or ideal of ability.

In my opinion, this assumption lacks foundation, and it certainly deserves more examination than we have given it.

In fact, I suggest that there is some reason to believe that progression is not wholly consistent with ability, and we must for severely practical reasons move away from progression if we want to secure a more accurate fit of income tax to ability.

This is not a new idea with me. Professor Josiah, now Lord Stamp, threw it out in a set of lectures which were published more than fifteen years ago, but he did not stress it, and it has been universally overlooked. The most serious difficulty is the time gap or lag. If we assume that income does indicate ability, I propose for your consideration this tract, namely, that it does so only at the moment of being in hand, not a year later.

We have devised our tax law, apparently, on the theory that ability is something so definite, tangible, permanent, solid, that it can be stored up in the icebox, and that twelve months after a man received and spent income, he could go to the icebox and cut off a slice and deliver the whole chunk to the government intact under the guise of its being a tax on his income according to his ability.

I have a suspicion that we have fallen into that error because of the dominance of first, the accountant, second, the whole accounting terminology, and the theory and doctrine as to income tax law and procedure.

Of course, the accountant is thinking about the business as an entity, and it is true that a business unit does accumulate income and it comes out at the end of the year with a certain amount of

income on hand, and, therefore, we are able to say that at the close of the fiscal year it has a certain amount of income; therefore, it would be entirely proper to impose a certain amount of tax on that income, because it is still in hand, at least it is still in the corporate or business treasury.

But take the ordinary individual who receives maybe a salary or other fixed income or receives variable income from any source. As he gets it he spends it. When he comes face to face with the treasury department on the 15th of March following, the income is gone. I suggest to you that such ability to pay as that income may have represented as it passed through his hands or came into his possession and control is also gone—gone with the wind and as completely as the wind has gone.

We have mixed our tenses. We say you had income, therefore you have ability. That doesn't make sense when you stop to think of it, and forget the emotional appeal that we all derive in greater or less degree from this grand social and humanitarian idea that we are going to distribute the burdens of government in some progressive relationship to something that we have deemed to be or considered to be ability to pay.

If what I have just said is at all correct, if there is a mixture of tenses here which is illogical and unsound and improper, then it would follow that even the levy of an international tax a year after the man had income and spent it would be quite as serious a violation as the use of progression. It wouldn't be as severe or as burdensome for him to bear possibly, but at any rate it would be in principle just as much of a violation as the use of progression.

But, you see, the use of progression is possible only on the concept or on the basis of the idea that ability accumulates over a period; because we couldn't apply progressive rates to several or to separate installments of this income as they come along. You have no idea where he stands in the progressive scale until you get him all nicely written up at the end of the fiscal period you are considering.

Hence, I come to the conclusion in the manner in which I started, that if we want to make the income tax fit with ability to pay, we must in some manner bring closer together the point of the imposition of the tax, the point of the registration in his possession of the income which presumably evidences and indicates the amount of ability that he has, and that the further we get away from that point of the receipt of income — we must get away from it by at least something like a fiscal year—in order to impose our progress, the further we are away from his actual ability to pay.

The acceptance of any such hearsay as I have just propounded would compel the most drastic sort of revision of our whole approach to income taxation, and I would agree with you that it is most unlikely that this will ever be done. Therefore, all I suggest

is that we just stop kidding ourselves about incomes according to ability to pay.

The present method of taxation is an extremely efficient instrument for getting revenue. That is the real justification for it, and as long as we need the revenue, we perhaps can't be too nice about the manner in which we get it. Therefore, I think we might just as well admit that our present schemes of progressive income taxation are after all an expression of what we in textbooks call the old cynical rule of taxation, namely, the ideal system of taxation is one which will pluck the goose so as to get the most feathers with the least amount of squawking. After all, that is what we are doing, and that is why I feel that the present scheme of progressive income taxation is likely to remain, why I feel that we are therefore committed to a scheme of taxation which hasn't very much relationship to ability to pay.

Thank you, Mr. Chairman.

Chairman Merrill: The next gentleman on the program is Bruno R. Neumann, of the research department of the National Association of Manufacturers, New York City.

Bruno R. Neumann (New York): Mr. Chairman, Ladies and Gentlemen: In the course of the last years I frequently had occasion to prepare factual reports on various tax measures enacted in foreign countries. I very often realized that it would be misleading to try to understand a foreign tax situation in terms of one's own experience and surroundings. Almost every industrial country has a tax which is the equivalent of our corporation tax. Trying to evaluate such foreign tax we tend to compare corporation tax in country A with the corporation tax in country B. It would be more helpful, however, to relate any foreign tax to the whole tax system of which it is a part.

In comparing taxes on an international scale we are faced with great variations in economic resources and business organization. Moreover, the ways of doing business, the fundamental concepts of business and commercial laws, and the part played by the state in economic affairs present such a variety of decisive facts making for a vast difference in the various tax systems that it is almost impossible to detect certain uniformities and find general "trends" in the tax legislation in foreign countries.

When I heard of Dr. Colm's topic first I thought that he would scarcely be able to give us more than his own version of the generally acknowledged fact that governments everywhere try to increase their revenue, and that they don't, and probably can't, exercise much care in levying taxes. Dr. Colm did say so much, but he was also able to offer a few cautious suggestions regarding the nature and significance of certain trends.

There is first the suggestion that the triumph of the income tax principle may coincide with the beginning relative decline of its practical importance. It is evidently Dr. Colm's feeling that for instance the introduction of the sales tax signifies such departure from the ability-to-pay principle. According to the nature traditionally attributed to income tax and sales tax, respectively, that view is certainly correct. May we not ask, however, whether circumstances can be such that the existence of the sales tax does not violate the ability-to-pay principle? Let us take the extreme example of the Russian sales tax which at present constitutes the chief tax in the Soviet Union. It seems to me that in a state where considerable differences in individual income are not supposed to exist, and where the government is supposed to take care of a great many individual and family needs, that in such a state the sales tax not only furnishes the simplest methods of raising revenue but is also justifiable with respect to the ability-to-pay principle. In other words, where individual incomes are the same the ability to pay is also the same. In concluding this point I would submit therefore that to the extent that individual incomes have been leveled out, as for instance in Germany, the sales tax does not present any great problem from the point of view of the ability-to-pay principle.

Dr. Colm, speaking of penalty and incentive taxes, suggests that those measures, which have been superficial and largely ineffective so far, might be considered as forerunners of a more fundamental concern for economic and social necessities in the development of the whole tax system. I wish they were. But is it not true that such a development presupposes an authoritative judgment as to the true nature of "economic and social necessities"? We all know that this is a highly controversial point, at least in democratic states. However, even totalitarian states do not display much initiative in the way of tax incentives. What they have done, democracies have tried also, and in most cases have tried it long ago. Both types of governments seem to have found out two things:

First, the power to tax is comparatively simple to use in a destroying and penalizing way.

Second, the power to offer tax incentives is not identical with the power to achieve the objective desired.

It seems to me that in order to pursue economic and social ends it is not enough to think of tax measures only, or mainly. They may be useful as supplementary measures. But whatever the extent to which it might be possible to employ them usefully, I think that the ends intended to be served by such a policy will be worthwhile only if they result in the enhancement of the country's productive capacity and wealth-creating power.

Thank you.

Chairman Merrill: Inasmuch as this program has brought out clearly to the fore certain international aspects of taxation, it seems to me that it would be rather fitting if before we throw the meeting open to general discussion, we might hear from at least two illustrious foreigners who happen to be with us this morning, Dr. Mann of the American University at Washington, and Dr. Henri Bloch, who is now at the University of Chicago. Perhaps in a few minutes they might add a contribution or point out some other sidelights upon these very interesting international taxation features which we have heard commented upon and admirably described by Dr. Colm. Will Dr. Mann kindly come forward?

Fritz Karl Mann (District of Columbia): I am very grateful for this opportunity, which I didn't expect at all, to say a few words about the very impressive papers I have listened to, inasmuch as I have been interested for many years in the same subject. Eight years ago I published my first book in English, quite closely related to the questions discussed today.

May I confine my remarks to two points. On the one hand, I may say I agree with the general statements of my colleague, Professor Colm. On the other hand, I must make a few objections. I agree with him that in comparative public finance there is a general trend in taxation; it would be a case of not seeing the woods for the trees, I suppose, if we said there is not a general trend.

If the income tax was a great fashion in the nineteenth century in Europe, now, during the twentieth century, it may not be the great fashion in public finance.

I agree with Dr. Neumann when he said that income taxation and the principle of ability to pay is not the same. We may find out other taxes which are also conforming with the ability to pay and which are not income taxes.

On the other hand, I would like to make one objection to the very interesting statement of Professor Colm. I feel that the rapidity of the development should not be overestimated. Chiefly, I think we should not only look to taxes officially termed as income taxes, but we should look at all taxes which have the nature, the character, and the functions of income taxes. And should I refer—I think it is not necessary to American institutions—especially to your payroll taxation, and I may say a few words about similar institutions which have been introduced for many, many years in Germany, in England, and France, and so on. Especially, I would like to refer to the so-called contributions to social insurance which in Germany, for instance, are about the same as an income tax paid out of the income of the wage-earner. It is gross income, of course, with several qualifications, but it is an income tax. If we are speaking about the trend of tax policies and the change in the structure of a tax system, I suppose that those contributions which

I prefer to call quasi taxes and not taxes, but which are taxes, of course, in their main character, should be added to the income tax, and if we would like to appreciate the rôle of the income tax, we should at the same time think that this addition to the income tax—that means, as you know in your own country, the rôle of this contribution, this payroll tax—is tremendously increasing.

You may suppose that is the same condition existing many years in European countries. First, we have not only a decline or stoppage in the development of the income tax, but we have an overproportion between the different types of income taxation, the old classical personal income tax is combined with more crude types of income taxation like the payroll taxes, and sometimes with poll taxes, and so on.

This is, I think, the main objection I would like to make to the paper of Dr. Colm. I appreciate very much the opportunity given me to speak to you.

CHAIRMAN MERRILL: Now, if Dr. Bloch is present we will hear from him.

H. S. BLOCH (Illinois): Ladies and Gentlemen: I did not know that I should have the honor of speaking before this assembly, and I am not at all prepared. Instead of interfering in this discussion between authorities on income tax in general, I want to come back to the subject treated this morning by Commissioner Eldon P. King of Washington. Dr. King spoke on the income tax convention between the United States and Canada which became effective in 1937. This convention has two aspects. First, it deals with the problem of double or multiple taxation, and second, it provides for cooperation between the United States government and the Canadian government in order to fight tax evasion.

This second provision of the convention is indeed a new element in American-Canadian tax agreements, but it follows a general program, I may say, a trend, in order to follow the terminology used today by several speakers. This trend was studied by the committee of experts of the League of Nations in 1924, 1925, and in 1927. At this conference schemes were formulated for international conventions to deal with tax evasion. The League of Nations discussed this question also in its assembly of October 9, 1936, and the fiscal committee dealt with it in 1937.

International cooperation in the matter of double taxation has been very strong, because such a cooperation is in the interest of all the partners. It is a means to protect the citizens from paying too much and finds therefore easily popular support. Such an agreement has only a character of protection.

An agreement to avoid tax evasion, however, has a repressive tendency and therefore finds opposition among a large number of

citizens. A convention concerning multiple taxation may be effective and reach its aim if it is concluded by only two countries. A bilateral agreement as proposed by the committee of experts cannot, however, avoid tax evasion. The evader may simply put his capital in another country which did not sign the agreement. Thus the result may be disadvantageous even to the nations which sign bilateral agreements.

This theoretical statement is, however, not always true in practice. An American-Canadian agreement may accomplish its purpose because of special geographical and political conditions. In theory, however, there should be an agreement between all the countries, a universal agreement. We have said that an agreement on multiple taxation is useful to all the partners. An agreement on tax evasion is, however, opposed to the interest of those countries which are a refuge of restless capital and receive special profits from immigrating money, often unknown to the tax authority to which its owner has to report. Countries like Switzerland and the Netherlands would never sign such an agreement. But there is still another factor which speaks against this kind of agreement in many cases.

There is no such tradition in international fiscal cooperation (when I say fiscal, I mean tax matters, this being the French way of speaking) as there is in civil and criminal law procedure. The capitalist who puts his capital in another country without paying taxes to his own government has often been compared with the political delinquent. His motives are indeed sometimes of a political nature. Either he thinks he is robbed by his government or he feels that his capital is threatened. Political delinquents are not extradited.

The tax claim of the state is a political claim and the debtor is not to be compared with a man who owes money to a private creditor. Collecting taxes is a political measure. Political measures are called "odious" by theorists of public law. In some cases it is no wonder that countries do not want to cooperate. How can one demand, for instance, that the United States extradite a man to Germany where he will be executed for having transferred illegally his capital which the German government otherwise would have taken away from him?

Or should we even allow the Germans to execute their verdicts in America? This is a case in which it is clear that cooperation is impossible. The German penalties are considered here as contrary to "public policy" or "public order" as it is called in France. Whereas in civil and criminal law the majority of the civilized nations agree on certain principles, in fiscal law it is not so. A capital levy would, for instance, be considered contrary to public policy in France and it would be impossible to permit another country to enforce such a claim in France — unless France itself

should introduce similar measures in the future. What is justice in one state is robbery in another.

It is obvious that agreements against tax evasion can be made only between countries of very similar constitutional law, and, therefore, similar conceptions of public policy. It is also necessary that the capital movement is bilateral and not a unilateral one, so that each contracting country is a beneficiary of the agreement.

The cooperation has to be effective for two purposes. First, the evader has to be denounced, that is, mutual information or administrative cooperation must be forthcoming. Second, one country must have authority to collect the unpaid taxes in the other and to obtain legal assistance if necessary, that is, legal cooperation.

This second clause is necessary in order to make an agreement effective. Suppose a tax evader invests his whole fortune in a foreign country and he emigrates as soon as he knows that the authorities of his own state will be informed. In that case his government cannot possibly enforce the law — unless mutual legal assistance is granted. But it is also understandable that a government is reluctant to make such concessions to another country, though it is an old custom in civil and commercial matters.

Administrative cooperation has been granted in several cases. France signed an agreement with Belgium in 1843, another one with England in 1907 and one with Monaco in 1925, providing for exchange of information on tax evaders. It was not until the 24th of December, 1936, that France and Sweden signed an agreement not only to furnish mutual information but also to lend each other legal assistance in order to obtain payment of delinquent taxes. This agreement works only to a certain extent. Incomes of French citizens in Sweden, known to the Swedish authorities but unknown to the French administration, will now most probably no longer remain hidden and vice versa. If they are periodical and come from real property there is little possibility even of evasion in the future. However, there are many cases where the capitalist may transfer his money to another country and in the future few will be so careless as to invest in Sweden with the hope of avoiding French taxes.

The agreement between France and Sweden excludes the mutual legal assistance for the execution of penalties. Only the tax claim proper is considered.

We do not discuss here the convention on double taxation which France and Sweden signed at the same date and we do not discuss either the issue whether Sweden or France secured a greater advantage. It is only important here to state the fact that two nations agreed on jointly fighting tax evasion. It may, however, be repeated that a bilateral agreement cannot fulfill its purpose in that field unless special circumstances such as those we recognized in the American-Canadian case prevail.

In 1929 Professor Edwin R. A. Seligman delivered an outstanding lecture before the Academy of International Law at the Hague. He foretold a new era of international peace and universal cooperation and he believed that universal tax agreements would help this evolution.

When we gathered at the Hague in 1937, there was no longer hope any more for this international universal cooperation and we came to new conclusions. We knew that instead of universal cooperation, there was only the possibility of a cooperation inside the democratic bloc, between a few countries, such as the monetary tripartite agreement between the United States, Great Britain and France. Thus the whole policy has to be changed. We have to come to a kind of financial mobilization.

When France suffered tremendously from the flight of capital, England did not help stem it. Rather, she encouraged capital flight from France. During the last months French officials negotiated with American officials about cooperation with the United States. The flight of capital from France to the United States has become stronger and stronger. America does not need that capital. Until recently it has been called "hot money." I think there is a chance of French-American cooperation along this line.

Thank you very much.

M. Slade Kendrick (New York): While Mr. Lutz was making his point respecting the income tax, it occurred to me that the individual liable for payment of such a tax might well be expected to make provision for its payment during the time that he has income, even though that time is, of course, in advance, as Professor Lutz indicates, of the period of payment. Such provision is common in the business of the world. I know that Professor Lutz has considered that point, but it does seem to me that he might enlighten us somewhat as the bearing of this provision upon the point he made regarding the income tax and ability to pay.

Mr. Lutz: Was that intended as a question to me, Mr. Chairman?

The gentleman is quite correct. I do take that into account. I might say that I have in the process of preparation an article for the *Bulletin* on this subject, and perhaps some of those points can be more fully dealt with there than I was able to deal with them here this morning.

It is theoretically possible that every one of these taxpayers ought to be a sufficiently good citizen so that every time he got a dollar in hand he would look at it and say, "Now I realize that so many cents out of this dollar are mine; so many cents, X number of cents in fact—particularly if you have progressive rates—belong to the government. I must therefore set up a special tax reserve fund

from January first until December 31st, I will accumulate so many cents, an indeterminate proportion, in fact, of each dollar, in that reserve account so that when the collector comes around on the 15th of March I shall be able to pay him in full." A nice theory!

But, how many people do that? How many people could you compel to do that? What defense have you for a tax law which says in effect, "We are going to tax you thus and so, and it is up to you to get ready twelve months in advance for that tax," because there is only one thing more certain and we know what that is." In fact, that is more uncertain.

I think that is asking too much of human nature. I think that a tax system that has to depend on that highly uncertain and undependable factor of human nature is not the right kind of a tax system. We have to have some other way of getting this fellow's ability to pay while he has it, and before it gets away from him, and it is a very elusive thing. It doesn't linger any more than the money in your pocket lingers. If that is the best case we can make, I think it is a rather weak case for the present system.

MABEL O. MAGEE (New York): May I suggest that the government send them a monthly bill the first of each month.

MR. LUTZ: Oh, yes. Of course, again you are anticipating the development of this idea that I didn't have time to go into this morning. I realize that we tried stoppage at the source once upon a time, and gave it up. We gave it up for one reason, because it was said to be too expensive, too burdensome. It is difficult; but, when you face the realities of the situation, and get down to the collection of an income tax in the only way in which such a tax can be adjusted to ability it does become a difficult tax and an expensive tax, and that is one of the things that has to be taken into account in all of this paean of praise that we have listened to for so long about the present method of doing it.

We have shifted to another method for one reason because it is so much easier and we can get a very beautiful ratio of administrative expense to collections because of the way in which we have ignored all of these other essential elements in the situation. Surely, if you could take it out of his check before he gets the check then he hasn't $100 or $300 or $500 a month to spend; he has that less the tax. Then you have it right down to ability to pay, yes.

H. K. ALLEN (Illinois): I should like to ask Professor Lutz if he would also apply his objection to the taxation of property and sales at uniform rates? For instance, in most states we are paying property taxes this year on the levy of last year. The justification would seem to be that property indicates taxpaying capacity; as we owned it last year.

Well, perhaps we will have nothing with which to pay the taxes this year, therefore is it objectionable and unsound to apply that sort of property tax?

MR. LUTZ: Mr. Chairman, I didn't get all of that question because I was diverted before I realized that the gentleman was going to ask the question instead of making a statement. But perhaps I can dispose of it by saying that by and large I am not very much disposed to regard the property tax as a tax based on ability to pay. I think we have other reasons for a property tax than that particular hypothesis.

I might add that so far as the payment of property tax is concerned, of course, it is a hardship, and the installment payment of property tax is certainly a move in the right direction. In New Jersey we pay our property tax in four installments, and to be sure, while the assessment is made in one year and the levy is made the next year, the more you split it up into installments the closer it fits at least your current ability to pay if not the ability that you had in the previous year.

MR. ALLEN: I might ask a further question of Mr. Lutz, then, whether or not he would approve taxation of income at progressive rates, if that could be applied, say, over quarterly periods or over a monthly period, or if it were administratively possible even to get it down to a period of a single day?

MR. LUTZ: That is cutting it pretty fine. In Germany during the inflation, I understand that there were periods during which they gave the workmen a half hour off two or three times a day and paid them so they could run out and spend their money before it lost any more of its value. It is possible that the gentleman has a point there. I haven't given it consideration.

LEO MATTERSDORF (New York): Much as I dislike to do it, I am constrained to rise in defense of the accounting profession. Last night and this morning it has been indicted, and I want to plead not guilty to the indictment.

Professor Lutz this morning said that most of the trouble seems to be because of the accounting theory—if I am wrong, correct me—as it is applied to the collection of taxes and therefore its relationship to the ability to pay. I say the indictment is faulty for the reason that accountants are not consulted, or rarely consulted, or no attention is paid to them when tax laws are drawn. Part of the lack of ability to pay arises from the fact that as we all recognize tax laws are neither good accounting nor good law.

If the accounting theory of income were adopted, we would be more nearly at a point where you would be taxing true income.

I recognize also that a speaker last night said that the accountant desires to have the scientific approach, that he wants to make of taxation a science. I say in answer to that, that accounting is not a science; every accountant recognizes that, so how can we turn around and try to make taxation a science?

We have that as an illustration in a number of things which I think will show that the income tax cannot be based on the ability to pay. The accountant desires to set up reserves. He wants to take these slices and put them into the icebox, not only to pay the income tax—and heaven knows we here in America think of that last—but to pay this, that and the other liability which is bound to come up. He wants to make provision in the profitable year so that he can take care of that in the unprofitable year.

But it is not as easy as that, because when you come to revenue laws, reserves cannot be recognized, and very sensibly, because if you take two people, one a conservative man, the other more of a gambler in the same line of business, they won't set up the same reserves, and you can't force them to. The consequence is that we are up against the proposition not of accountancy but, as Professor Lutz has just said, human nature, and you cannot change that.

A question was just handed to me which I think might be apropos. If the statement is true that the income tax is not based on ability to pay, and if a man spends it before the tax collector comes around, the question is, how do we manage to collect any income tax? I sometimes wonder myself. I feel that if the need, the immediate pressing need for revenue was shoved in the background in this sense, that if taxpayers were permitted to more equitably report their income, in the sense that they be permitted to take deductions which have a relationship to income, a provision for instance such as we have in the New York income tax law, to the effect that you may claim all deductions which are related to items of income which have been reported in the return; if also, we be permitted to deduct depreciation rates which are more nearly in accord with what engineers, accountants and management feel to be the correct rates, rather than to lower them for the immediate pressing needs of the revenue, I think we will come to the point where we will be more nearly able to say that the income tax is based on ability to pay.

On the other hand, I have given up trying to think of a tax which is based on true ability to pay.

Thank you.

J. Wilner Sundelson (New York): In connection with Professor Colm's paper, I would like to say just this: I think that there might be some confusion through the choice of the two criteria which are not mutually exclusive. In discussing the question of ability to pay as separate from the taxes changing the status of economic neutrality, I find that it is necessary to point out that a

great many of the so-called interventionary taxes are in one way or another designed to work out an individual or national interpretation of ability to pay.

Specifically, some of the taxes that Professor Colm mentioned I think can be shown to work in their individual countries along with their own concepts of ability to pay. For example, the taxes which he mentioned linked to demographic policies, have had the effect of increasing the burden on people without families, on bachelors and on childless couples, and they have been more effective in that than in their non-fiscal motive, namely, in encouraging large families or in encouraging marriage.

Another point has been the administrative breakdown of the simplification of the income tax. Italy, for example, has found it almost impossible to collect a reasonable amount of income from the types of income taxes based on voluntary declarations. So there has been a vast amount of taxes in Italy attempting to collect income wherever it can make its appearance on the surface. The Italians have gone so far, for example, as to give the tax-collecting agencies permission to substitute expenditure bases, and in connection with their corporate taxation, we find similar tendencies.

I think that in Germany the national attitude encourages a development of an ability-to-pay policy that can be understood from the German point of view, and a great many of the taxes which would to us appear as purely interventionary can be put into that group.

M. D. Bachrach (Pennsylvania): I want to add just a word to what Mr. Mattersdorf has said so that the score will be at least two accountants against eight college professors.

I don't profess to know anything about the theories behind the taxing system, but one thing that has always appealed to me in twenty years of public accounting practice is that I always believe that the distinction chiefly between our American taxing system and that of the foreign countries, particularly before 1933, is that where the foreign countries derive most of their revenues from the so-called indirect taxes, we in this country derive two-thirds of our revenues from the so-called direct taxes.

I believe that it would be deplorable if in a democracy such as ours, the tendency which is now prevalent to raise revenues more and more by way of indirect taxes should be permitted to continue. I think that our people should know the cost of government, they should be aware of the burden of taxes, and they cannot be aware of it when taxes are imposed in a hidden manner.

So I am in favor of lower exemptions, a broader base, and a constant knowledge on the part of our people that the cost of their government is before them because they know what tax bills they are called upon to pay.

As a matter of fact, I would be more in favor, I would justify, a Roman tax on funerals, or a Russian tax on bears, or even an Italian tax on bachelors, since by those means, whether they be good taxes or bad taxes, the people who pay them know that they are being taxed.

CHAIRMAN MERRILL: Dr. Colm, would you care to reply to some of these gentlemen?

MR. COLM: I would like to confine my remarks to those objections which were raised against the program of trends in international tax legislation. I don't want to enter into controversy about the theoretical points, especially; I am afraid of this battle between the accountants and the college professors.

Gentlemen, you know the fact that if you have three German professors, you have four opinions, and I think this has been proven to you here, because I must say that although I am not ready to give up any of the statements which I made, I am also to quite an extent in full agreement with my critics, because I simplified and over-simplified my statement, so I am grateful for certain qualifications.

Yet I can't agree entirely with Professor Neumann who said, first, there never existed such a thing as ability to pay taxation, and second, who said there is no trend away from it. I can't get this straight. It seems to me a certain contradiction. To my mind, it is entirely correct that taxation always got the funds where they were found, and yet, there is a difference. There has always been an attempt to bring taxation into a certain accordance with ideas of tax principles of just taxation. This gentleman said he didn't know how the income revenue was collected. If there was not a certain idea that it is justified to raise a tax on the basis of income, then you wouldn't get a cent except really by force and not by voluntary cooperation of the taxpayers.

So, to my mind, there is a certain danger in emphasizing too much the cynical rule of taxation. It is true, the state, the government, must have the money. That is the main thing to start with for each taxation. But if we stop there, then I think pretty soon the government will not get any money, because it cannot rely on the cooperation of the taxpayers unless the tax legislation is brought into accordance with certain ideas about justice in taxation. That is why I believe there are other principles of taxation besides this cynical rule which we agree is the main rule of taxation.

As to the question of the uniformity of the development: I quite agree with these speakers who said that I interpreted a trend where only anarchy prevails. Yet, one sentence in defense of the statement that there are certain trends. To my mind, the common factor, as I said, is the increasing tax levy in all countries. I think this trend

has not been challenged by anybody among the speakers. If that is a greater point, then certain uniform developments follow of necessity, because if you study the recent history of taxation through, let me say, 100 years you always see certain countries are ahead very often for political reasons, because of war finance, and so on. These countries had a higher level of taxation before other countries had it. Then certain problems came up. Take for instance, only in one example, coordination between federal, state and local taxation. This problem became urgent first in those continental countries which had a high level of taxation. Now, for instance, other countries like the United States are following suit. The tax level is rising, and you get exactly the same problems in this country which other countries on the federal basis had already decades ago.

Certainly, the constitutional and historical situation is different, but the same problems arise. Therefore, it is only a further example of such general trends—with an increasing tax level certain problems come up of necessity—for instance, the exhaustion of the income tax, either political, fiscal or economic, and then the tax forms and the whole problem of business taxation.

It is no longer possible to say only that the corporation is an association of certain capitalists. It is an entity in itself, and again you find that the tax level was higher already in the past. When the tax level was high in the past, there we find the first approach to systematic business taxation, and I think it is of necessity that this problem will come up in other countries, too.

I didn't agree with Mr. Neumann when he said there are such important examples. He said I wouldn't make the statement in London. I would do it, because in London, in England, through the national defense contribution, we have a decisive turn, and there we observe already the decline of percentage of income derived from income taxation.

In Canada we have still an increasing trend. The percentage of revenue derived from income taxation still increased during the last period. But this belongs to the category of countries which I mentioned especially which enacted an income tax only in a relatively late period, which I think was in 1917, as we were told today.

I have only one sentence in reply to Dr. Mann, who said, rightly, that there are other taxes than income taxes which correspond to the ability-to-pay principle. I expected he would mention the inheritance or estate taxation. He mentioned the payroll taxes as they are enacted as contributions for social insurance. I would regard them more as one factor in the whole business taxation. I would regard them more as payroll tax than as ability-to-pay tax. This leads me to the remark that many elements in income taxation certainly do not correspond to the ability-to-pay principle. A very high percentage of the total income tax collected in Germany is payroll tax.

Now if you will consider the following point: A worker, let me say, is employed through one week. Then he is fired, and is unemployed the whole year. For this one week he has to pay the income tax. It is deducted from his pay envelope. Originally when the law was enacted, he could have asked for a refund at the end of the year if his total income remained below 1100 marks—about \$300. This has been cancelled because the cost of administration for this whole refund business was so enormous that they absorbed quite a percentage of the total tax revenue.

A worker who has an income, let me say, earned income, perhaps of 25 marks or dollars the whole year, because that is a little period—he was unemployed—has to pay income tax, and he has to pay the social insurance contributions. I can't say that this corresponds to the ability-to-pay principle. It corresponds rather to a type of business taxation where we say that the whole wage level is more or less adjusted to the fact that these taxes are collected and we have business taxes collected on the basis of profit, capital, payrolls, and so forth.

So far I believe that this is one more element of this whole problem of business taxation, which to my mind should be on the agenda of future tax considerations.

CHAIRMAN MERRILL: Gentlemen, Chairman Leland has some notices to read.

CHAIRMAN LELAND: The first thing I want to do is to announce the resolutions committee. The following states have designated these as their representatives on the resolutions committee. You will remember that committee is under the chairmanship of that great resolver of most resolutions so far as the association is concerned, our good friend, Henry Long.

Colorado, Mr. Wilson; District of Columbia, L. A. Carruthers; Florida, J. Paul Gaines; Indiana, Philip Zoercher; Missouri, Clarence Evans; New Mexico, Paul Harris; New York, John J. Merrill; Ohio, Kenneth M. Lloyd; Oklahoma, C. C. Brown; Utah, Walter Moyle.

The rules provide that when the delegates from the states do not notify the secretary of their appointments the chairman shall complete the roster of the resolutions committee, which I am doing as follows:

Alabama, Henry S. Long; Arkansas, John H. Page; Arizona, D. C. O'Neill; California, Carl C. Plehn; Connecticut, K. M. Williamson; Delaware, M. M. Daugherty; Georgia, S. O. Gillespie; Illinois, C. W. Terry; Iowa, Louis E. Roddewig; Kansas, Clarence Smith; Kentucky, James W. Martin; Louisiana, F. W. Raggio; Maryland, Harry O. Levin; Massachusetts, Norman MacDonald; Michigan, R. Wayne Newton; Minnesota, George F. Gage; Missis-

sippi, A. H. Stone; Nebraska, Frank G. Arnold; New Hampshire, John R. Spring; New Jersey, J. H. Thayer Martin; North Dakota, H. C. Young; Oregon, John H. Carkin; Pennsylvania, E. M. Elkin; Rhode Island, Edwin L. Leahy; South Carolina, W. R. Bradley; Tennessee, Walter Stokes; Texas, Albert K. Daniel; Vermont, George B. Young; Virginia, C. H. Morrissett; West Virginia, Ernest K. James.

The resolutions committee will meet at the call of the chairman.

The next thing that I am called upon to announce, and I do so before I forget it, is that the dinner tonight is to be informal.

The next thing I want to do is to go back a moment to the suggestion that was made by Mr. Elliott at the close of his paper, suggesting that the relationships between the students of taxation in the United States and those in Canada ought to be much closer. The oldtimers here know that in the early days the National Tax Association took first the name of the National Tax Association, and then the name of the International Tax Association. Our internationality consisting of a few members in Canada and occasionally some in Mexico, also a few of our provinces and states abroad.

We have also had two conferences in the Dominion of Canada, as I recall, and it has seemed fitting to some of us that the relationship between American state officials, American professors, American lawyers, and others interested in the problems ought to be closer with the same groups abroad, and that something very much may be needed to develop fully Mr. Elliott's suggestion.

During the last two years I have made some efforts to try to move things in that direction, and Mr. McMahon, in Canada, has been very helpful and very much interested. I thought if he would talk to us for just a minute this morning I would like to have him tell us just what has been going on there. I will guarantee he won't talk long. Mr. McMahon.

Chairman Merrill: I need not introduce Mr. McMahon; you have known him so long. He has been with us frequently, and always when he speaks he speaks so interestingly that he really needs no introduction to us.

L. I. McMahon (Montreal, Canada): Mr. Chairman, Ladies and Gentlemen: That even an Irishman could speak after that introduction is mysterious to me.

However, I shall tell you what has taken effect during the past few years and of our desire to bring back into this organization the international spirit that first moved it, and I think from the addresses that you have heard today, particularly from Mr. Elliott, that we possibly have a great deal—not possibly but undoubtedly—to learn one from another.

The contrast which Mr. Elliott has shown you has no doubt inspired in your mind a desire to know even more. Mr. Philip Zoercher three years ago, when I was made an honorary member of the executive committee, asked that I should take up with the various governments throughout Canada this very question and to try and get reciprocation. I did so, but unfortunately politics at the time were in a turmoil. They are still in some sections, but nevertheless I was successful in having the federal government represented the following year.

Now, you see, we have three of the seven provinces and the federal government working along these particular lines. We have had that cooperation to that extent. The following year our president asked me if I wouldn't endeavor to bring the taxing authorities to go further along those lines, and this is as far as we have gotten so far.

There are individual corporations such as the Sun Life Assurance Company which is represented by Mr. Reid, the Royal Trust Company of Canada, and many others who from time to time sent their representatives privately. We are getting quite a number of those in as members of this organization, and we are ready to work still further along these particular lines.

We have in Canada what we call the Canadian Tax Conference, and the Citizens' Research Bureau. That is directed by Dr. Horace L. Brittain, who is second to very few in the tax world, I assure you.

If it is the wish of this organization to follow along the suggestion of Mr. Elliott, I should be very pleased with his cooperation and that of Dr. Eaton to approach Dr. Horace Brittain and to get on the program for next year, and bring us still closer together in the study of taxation for our mutual benefit.

Now I am almost up to my minute, but I shall take the last ten seconds in going still further and say—and I think this is exactly the thought that Mr. Philip Zoercher had in his mind at the time—that because of the stressful period throughout the world that we are going through, and our security in comparison with others, and in view particularly of the subversive movements that are endeavoring to creep in, or that some are endeavoring to bring into our respective countries, anything whatsoever that can bring Canada and the United States closer together along the policy of the good neighbor, which is your president's favorite topic—I mean the president of the United States, of course; (laughter) no doubt it is coincided in by our own president—is well worth while.

I think that not only our tax matters will profit by our mutual getting together, but I think that a far greater influence throughout the respective countries and also far beyond our respective countries will take effect. I mean the security of the world depends a great deal upon both Canada and the United States and the influence that those countries can in that friendly and cooperative way send out.

Chairman Leland: I feel that I can't close this morning's session without telling you that just as the session opened this morning, our chairman of local arrangements, Mr. Berry, learned of the death of his mother. It was but a week ago that he conveyed to me that same information as to his father.

Much of the success of the convention here in Detroit has been due to the effort which Mr. Berry has given to this work. He has arranged singlehanded, I think, all of the entertainment program for the ladies. He worked with me to make the sessions here in this town, the arrangements for the delegates, as interesting and as extensive as possible. It would not be fitting that I shouldn't tell you this very, very sad thing, and let you know that our debt to him is indeed great, and that most of the success particularly of our physical arrangements and of the entertainment is due to him and to his work. There have been few men in my knowledge and connection with the association who have worked as long or as hard as Mr. Berry. I am sure he has all our sympathy and I feel that you ought to know that fact.

We will stand adjourned until two o'clock.

(The meeting thereupon adjourned at 12:20 o'clock p. m.)

TWELFTH SESSION

THURSDAY, OCTOBER 27, 1938, 2:10 P. M.

CHAIRMAN LELAND: If I might have your attention to make one announcement, we will begin promptly.

There are a few people who have the impression that only the old-timers are supposed to come to the dinner tonight. That is a grave error. The dinner was an attempt to get some of our old members back to the conference in order that we, the youngsters, might recognize them and give a banquet in their honor, but charging them for their own tickets.

We hope that all of you will make special efforts to come tonight and make it a rousing success. I want to say that it is informal, and that we will try to have a good time, at least up to the point where the president is supposed to give an address. Don't forget about that banquet.

The general session this afternoon is one, I think, of exceptional interest. I have asked my good friend Senator Edmonds to preside at this session, and it gives me great pleasure to turn the gavel over to him.

Senator Edmonds!

FRANKLIN S. EDMONDS, presiding.

CHAIRMAN EDMONDS: The subjects are large and important. The speakers are fine and tested in the work of the National Tax Association. We will get down to business at this twelfth session. The first topic is the "Effects of Tax Exemptions and Tax Differentials on the Location of Business," and the paper will be presented by Dr. Harold M. Groves, professor of economics at the University of Wisconsin.

Dr. Groves!

THE EFFECT OF TAX DIFFERENTIALS AND TAX EXEMPTION UPON THE RELOCATION OF INDUSTRY

HAROLD M. GROVES
Professor of Economics, Univ. of Wisconsin

Introduction

The subject of the migration in industry to escape taxation and of the effect of taxes upon industrial development is of perennial interest. For many years a debate has been raging as to whether or not nations should tax foreign trade in order to foster their own industry or prospective industry. The same issue as between the states and their divisions was precluded by the provision in the federal constitution against internal tariffs. Yet some states have devised and enacted certain legislation which operates to keep their internal market free from the exploitation of outside goods. Most notable of these measures is the tax on the sale of oleomargarine, a sort of state tariff in disguise. And both states and municipalities have found many other means for fostering industry and luring it to locate within their borders. For many years the development of state and local tax systems has been much influenced by the fact that most governments fear to apply policies so distasteful to industry that it will move or expand elsewhere. Some states and municipalities have gone further to offer more positive attractions for new industry.

For many years the South resented the protective tariff as an imposition upon its agricultural population to promote the industrial prosperity of the North. The South is now "getting even" to a certain extent, by out-doing the North in its favors to industry.

While concessions to industry direct and indirect are no recent development they have taken on new importance during this depression. Competition of all kinds has been a little keener. Many communities have been concerned not so much with gaining new industries as with holding old ones. Others have sought new industries as a means of livelihood for their unemployed citizens.

Forms of Industrial Relocation

The newspaper headlines usually suggest that the relocation of industry is a matter of its moving from high pressure to low pressure areas. However, it is generally agreed among students of the matter that actual migration of going plants is only one, and probably a minor one, of the ways in which industrial development takes place. A second type of differential development occurs when new industries start in some communities and not in others. A third

type occurs when branch plants are developed by existing industrial establishments. A fourth type occurs when existing plants grow and prosper in some communities and not in others. A study of the first three types of differential development made by the civic development committee of the National Electric Light Association and the policy holders' service bureau of the Metropolitan Life Insurance Company covered 2,084 communities in the United States and Canada.[1] The survey found relocation accounted for only 9.4 per cent of the plants and 18.7 per cent of the employees gained by various communities. New industry accounted for 81.8 per cent of the plants and 56.3 per cent of the employees gained; new branch plants accounted for the remainder representing 8.8 per cent of total plants and 25 per cent of the total employees gained.

Importance of Taxation in Business Development

In 1929 the 1927 income tax returns of Wisconsin metal manufacturing corporations were tabulated. The study showed a ratio of taxes to net income of 40.3 per cent. This calculation included the corporations with losses as well as those with profits. The figure is impressively large. However, the ratio of taxes to the cost of manufacture was calculated to be 3.09 per cent. The ratio of state and local taxes to the cost of manufacture[2] was 1.65 per cent; the corresponding ratio for state taxes (net income tax) alone was .63 per cent; for local taxes (real estate and personal property taxes) 1.02 per cent; for federal taxes (net income tax) 1.44 per cent.[3] These figures were gathered before the depression and the result might be somewhat different now. The major change, however, would probably be in a higher per cent of federal taxes. Federal taxes on industry have to be paid wherever industry is located and therefore are not a factor in relocation. Of the 1.65 per cent which was the average ratio of state and local taxes to cost of manufacture by no means all could ever be escaped by a change of location. Assuming that half the burden could be wiped out by a change in location this would represent eight-tenths of one per cent of the cost of manufacture. If the wages of labor represent half the cost of manufacture then a difference in wage levels of less than 2 per cent should be more important to a corporation in choosing a location than any probable tax advantage which might be offered.

[1] Civic development committee of the National Electric Light Association and the policy holders service bureau of the Metropolitan Life Insurance Company, *Industrial Development in the United States and Canada*, 1926 and 1927.

[2] Real estate and personal property taxes (but not state and federal income taxes) were included in cost of manufacture.

[3] Edgar H. Auerswald, *The Importance of Taxes to Wisconsin Metal Manufacturing Corporations*, (1929) unpublished manuscript.

This analysis to be sure suffers from the fact that the ratios are based on averages. Some particular company might have had a considerably higher ratio of taxes to cost of manufacture than 3 per cent and a considerably higher ratio of state and local taxes to cost than 1.65 per cent. Moreover, income taxes which constituted two of the important taxes paid by the corporations are usually not reckoned by corporations among the costs of manufacture. They were not included as costs in the tabulation but it may be misleading to compare these taxes with costs. Nevertheless the comparison does give a picture of the quantitative importance of taxes in the budget of the average manufacturing corporation.

Tax advantages are rendered still somewhat less important when the quality and quantity of governmental service are taken into account and that these factors are likely to have some direct correlation with tax burdens. "Government is like any other commodity in that the cheapest price does not necessarily indicate the best bargain." [4] In addition the quantity of local indebtedness and the special assessments of a given community must be observed.

If a tax advantage in one locality is attended by more special assessments or greater indebtedness than are found in others, then the advantage may be illusory or temporary.

From what has been said it appears that any possible differential advantage in taxation would be a relatively minor matter. Nevertheless the speaker knows of one large concern in the Middle West which has calculated that it pays taxes some 300 per cent higher than it would pay in another location in a neighboring state. The assertion has been made, and is probably true, that this plant could save enough in taxes by moving to pay for its plant in a few years. However, it is probably also true that it could save enough on a lower differential in labor costs or in freight rates, or in the cost of materials also to pay for its plant in a few years.

Several studies have sought by questionnaires to determine from industrialists themselves why they chose a particular location or moved from one to another. The survey of 2,084 communities above referred to listed 16 major reasons for such choices. The four most important were markets, labor, transportation and materials. Taxation was placed twelfth on the list. The study covered conditions in 1926 and 1927, and some critics have thought taxation would be given a higher rank today. A study by Charles E. Murphy [5] of the situation in New York in 1935 rated racketeering in business and labor as the most important reason for moving. High rents were placed second and high taxes, third. A study of "Industrial Trends in Wisconsin" by Edwin M. Fitch and Ruth L. Curtis in 1933

[4] Tax Policy League, "Business Migration and Taxation," in *Tax Policy*, October 1, 1937, p. 27.

[5] *Ibid.*, p. 9-12.

concluded that the original location of manufacturing plants was, in the great majority of cases, not a matter of deliberate choice; it was generally determined by the accident of the residence of factory owners rather than by comparison of the advantages of cities.[6] "The reasons most frequently mentioned for preferring other locations were not taxes and factory laws, as might have been expected, but nearness to consumer markets and to materials. At the same time, favorable taxes and factory laws were often advanced as the principal advantages of locations outside the state." [7]

Other studies have approached the problem from the standpoint of the statistics of industrial development. All those studies the speaker is acquainted with have failed to find a positive correlation between tax differentials and industrial development. This includes two studies in Wisconsin,[8] a recent study made at the University of Illinois,[9] a study of the Southern states by Professor Martin of the University of Kentucky,[10] and a study by Claud W. Stimson.[11]

Along with the uncertainty of the effect of favorable tax treatment on location of industry has gone the parallel question of which of the taxes is most conducive to industrial relocation. It is generally assumed that industry is most resentful of state income taxes. However, several industries which have left New York City complain particularly about the city sales tax. The state income tax as a developmental tax policy has one important advantage: it levies no taxes until and unless a business has a surplus above expenses. If a corporation is doing well in a given environment it may hesitate to move even if its taxes are high.

Importance of Taxation as an Influence upon Legislation

Whether or not taxation is a vital factor in the relocation of industry is open to question. But there can be little question that the threat of relocation is a vital factor in shaping state and local tax systems. The author knows of one liberal state legislature which

[6] Edwin M. Fitch and Ruth L. Curtis, *Industrial Trends in Wisconsin*, Bulletin of the University of Wisconsin, 1933, p. 7.

[7] *Ibid.*, p. 8.

[8] Geo. L. Leffler & Harold M. Groves, *Wisconsin Industry and the Wisconsin Tax System*, 1930, Wisconsin Bureau of Business and Economic Research, Bulletin No. 1; Frank A. Hanna, *Wisconsin During the Depression*, 1936, Wisconsin Bureau of Business and Economic Research, Bulletin No. 5.

[9] Geo. A. Steiner, *The Tax System and Industrial Development*, 1938, Bureau of Business Research, Vol. XXXV, No. 58.

[10] James W. Martin, *The Possibilities of Income Taxes as Source of State and Local Revenue*, p. 21.

[11] Claude W. Stimson, "The Stimulation of Industry Through Tax Exemption," *The Tax Magazine*, May and June, 1933, Vol. XI, Nos. 5 and 6.

actually modified its inheritance tax because one old person of considerable wealth threatened to leave the state and establish residence in California. Quite characteristically the state legislature took no pains at all to determine whether or not the California inheritance tax law was less favorable than that of the state which made the change. There never has been a debate concerning the adoption of a state income tax in any state so far as the speaker knows, where the threat of industrial migration did not play a large part in the deliberation. If state legislatures are quite conscious of legislative incentives as a factor in industrial development, city councils are even more so. Recently the newspaper in a small city in Wisconsin published the following editorial comment. "It takes money to attract industry! With cities all over the country holding out large morsels as tempting bait, every industry is an economic sucker, if it does not seek a city which gushes forth alms in order to get the company to locate there." [12]

Local Incentives Versus State Incentives

Most of the studies of the relationship of taxation to industrial development have proceeded on the assumption that state taxes are more important than local taxes in industrial relocation. The study of metal manufacturing corporations above referred to showed that in Wisconsin local taxation constitutes on the average 1.02 per cent of the cost of manufacture as compared with .62 per cent for the state taxes. During this depression particularly city councils have been at least as active as state legislatures in offering tax incentives to industry.

Forms of Municipal Inducements

Tax concessions are only one among many inducements offered by cities to attract new industries. Among the others are cash bonuses, loans, donations of site or building or both, or provision of same at nominal rentals, guarantees of favorable labor conditions and so on. Some states and municipalities advertise for new business. Quite frequently inducements are offered by non-governmental agencies such as chambers of commerce or "industrial development corporations." Some are offered by municipal governments without legal authorization. If sanctioned by strong local public opinion, illegal agreements may afford no great hazard for municipal officials who may be personally liable for misappropriation of funds. At least one state, Mississippi, now legally sanctions public borrowing and the expenditure of public money to buy or build industrial plants for leasing to private industries on terms approved by the State Industrial Commission and in accord with the public welfare. The

[12] South Milwaukee Journal, April 4, 1938.

preamble states as major purposes of this legislation the importance to the state of a business between agriculture and industry and of providing wealth-creating work for unemployed citizens.[13] The law has been sustained by the supreme court of Mississippi in spite of the following provision in the state constitution: "The credit of the State shall not be pledged or loaned in aid of any person, association or corporation. . . ." The court said that "this state in comparison with others has few such enterprises (manufacturing plants) and it has long sought in vain to procure them by offering them special inducements, for example, exemption from taxation." A positive incentive seemed no less appropriate to the court than a negative one.[14]

Mr. Thos. L. Stokes, reporter for the Scripps-Howard newspapers, in his series of articles entitled "Carpetbaggers of Industry," [15] reported one example of demands upon Augusta, Georgia made by an industry in a neighboring state as a condition of relocation:

> "While we would prefer to have a new building designed particularly for our manufacturing requirements, we would be willing to entertain a proposition with you, providing that the city of Augusta would agree to do the following things, and make such concessions as are indicated herewith:
>
> "1. Without expense to us, repair and condition all buildings and property suitable to our requirements, a general outline of which is submitted as Schedule I attached. (This outline is contained in two and a half closely-typed pages.)
>
> "2. Without expense to us, widen and put in usable condition existing roadways approaching to front and rear of property.
>
> "3. Furnish railroad siding without expense to us.
>
> "4. Furnish water power free of cost to us for a period of ten years.
>
> "5. Furnish water from city mains free to us for a period of ten years.
>
> "6. Relieve us of all city taxes for a period of five years.
>
> "7. Establish reasonable basis of assessment upon which taxes will be established after five years.
>
> "8. Reimburse us for expense occasioned by and incidental to dismantling fixtures and equipment at present location; to moving said machinery, fixtures, and equipment and supplementary factory utensils to Augusta, Ga.; and to the installation of all machinery, fixtures and equipment at factory in

[13] Session Laws of Mississippi, Special Session, 1936, Chapter I.

[14] *Albritton* v. *City of Winona*, 178 Southern Reporter 799 (1938).

[15] Thos. L. Stokes, "Carpetbaggers of Industry," reprinted from New York *World, Telegram,* and other Scripps-Howard papers, pp. 38-39.

Augusta. It is understood that the aggregate amount paid us for such purposes should not exceed $5,000.

"9. The city and/or state to agree to pay 50 per cent of the cost of training operators.

"10. The city of Augusta to use its best efforts with the Post Office Department to establish a post office address to be known as Sutherland, Ga. (This was the name of the old factory site.)

"11. The city of Augusta agrees to permit us to occupy said Sutherland building and properties for a period of ten years, or until such time as we have paid $1,500,000 in wages to employees engaged at the Sutherland plant, and such occupancy to be without expense to us as tenants or otherwise.

"12. At such date as we have paid $1,500,000 in wages to employees at the Sutherland plant, we are to receive full title to the buildings, property and water rights and privileges that are connected with the Sutherland plant.

"13. City of Augusta to cooperate with us in establishing beneficial commodity rates."

Augusta went a long way toward meeting these demands but not far enough to satisfy the industry.

In the more narrow field of tax concessions several states permit municipalities to exempt new industries for a period of five, ten or fifteen years.[16] The exemption may be from local taxes only, but may also include state taxes as well. Exemption may be by contract with the state; or mandatory by state legislation; or by specific action of the municipality, usually with a favorable referendum vote. Exemption may include buildings only, or land and buildings, and may apply to new construction or to old property under new ownership. State laws of this kind are prevalent in New England and the Southern states. Though nothing new, their use during the current industrial depression has been much more common than formerly. Outside of these areas the practice of rendering tax concessions to new industry is not authorized by law, and indeed is strictly forbidden in several states. An examination of newspaper clippings indicates that inducements of various kinds are quite widespread in Wisconsin where they have no legal sanction at all and have encountered a hostile opinion from the attorney general. A survey of the National Department of Municipal Officers for 1936 [17] showed that 90 per cent of the cities reported no inducements to new industries. However, the survey covered cities with populations of over

[16] National Association of Assessing Officers, *Exemption of Manufacturing Plant and Machinery from Taxation,* Bulletin No. 19, 1938.

[17] National Department of Municipal Finance Officers, "Tax Exemptions and Abatements offered by Cities to Attract New Industries," 1936.

50,000 only, and the practice is much more widespread among smaller cities. The industries most amenable to special inducements have been the textile and shoe manufacturing industries.

Motives of Industrial Tax Exemption

The motives behind tax exemption and other special inducements to industry may be negative or positive. The negative motive may appear in a small city with an industrial population which is left in desperate straits by the failure, removal, or threatened removal of an important factory. Without the factory in operation, the city is badly demoralized. Hundreds or thousands of workmen seek public or private relief; the real estate market collapses as people leave town or lose their homes; the tax rolls suffer from delinquency; and so on. In these circumstances it is likely to appear to the city council that most any subsidy whether or not legal, which brings in an industry or keeps one going is an exceedingly good investment of public money.

The United States Supreme Court in a famous case (*Citizens Savings and Loan Association* v. *Topeka*) [18] decided that direct subsidies for industry involve the expenditure of public money for a private purpose and were illegal. As a matter of fact in some industrial towns the retention of the local factory may seem a public purpose of the first order.

The positive motives are more complex. A community may wish for new industry as a matter of pride or as a matter of improving local business and real estate values, or increasing the local tax base, or improving the local balance between the rural and urban population and offering more diversified opportunity to the population. In the South particularly, the earnings in agriculture are so exceedingly low that most any opportunity for industrial employment even at low wages seems an important advantage. Here we have the arguments for the protective tariff, particularly the infant industries argument, applied on a small scale.

Considerations of State and Municipal Policy in Granting Tax Exemptions

Is it a sound policy for states and municipalities to grant tax exemptions? Certainly something will depend here upon the universality of the exemption program. If one merchant keeps his store open on Sunday while others are closed he can make money by so doing. But if all merchants follow the same policy none of them are benefited. Similarly, if only one municipality were to offer special tax advantages, it could attract, perhaps, a considerable

[18] 20 Wall 655.

number of desirable industries, but when the favors are universalized they cease to be effective. Of course, one municipality can outdo another in its inducements. The question then arises as to when and where will the competition in subsidies stop?

Whether or not it is good policy for municipalities to offer special inducements to industries may also depend upon the suitability of the industry. The infant industries argument usually accepts the proposition that eventually industry will be able to stand entirely on its own feet and pay both satisfactory wages and taxes. Industry will not eventually become self-supporting unless it is reasonably well suited to its environment. Some industries, called "hobo" industries, have had undesirable leadership and have specialized in very speculative ventures. These industries make a racket out of municipal inducements. Advantages granted to such concerns are likely to prove one-sided arrangements with the municipality getting the short end.

An example of a case of this kind and one involving an interesting court decision occurred recently in Wisconsin. A municipality borrowed $100,000 to give a bonus to a new industry and collected the money through public taxes. The industry agreed to provide a payroll of a million dollars over a ten-year period and offered a bond to secure its faithful performance. The company defaulted upon its contract and the municipality sued the surety company. The state supreme court [19] denied the right to collect on the bond. The court said the municipality's procedure was "permeated with illegality," that the contract was opposed to public policy and that to assist the municipality to collect would encourage dishonest transactions. While no study was made of the industry involved in this case it seems highly probable that it was an exceedingly poor gamble from the standpoint of the municipality.

Finally, municipalities need to consider both sides of the balance sheet when deciding on special inducements. New industries may involve not only tax concessions but also a large amount of additional public expenditures particularly if a new labor supply must be imported. Some cities are committed to the policy that special

[19] *Wendlandt* v. *Hartford Accident and Indemnity Co.*, 222 Wis. 204, 268 N. W. 230 (1936). No attempt has been made to explore decisions in similar cases arising elsewhere. See, however, *N. Y. Central Co.* v. *City of Bucyrus*, 126 Ohio 558, 186 N. E. 450 (1933), in which a village purchased a site and buildings for railroad shops on condition that they were to be used permanently for that purpose, and in case of violation of such agreement by the railroad the property was to revert to the village (now city). The court held a special statute, under which this agreement was negotiated, invalid but allowed the city to recover its property. 126 Ohio 558. As previously stated, the Mississippi statute authorizing the appropriation of public funds for industrial construction and operation has been sustained by the Supreme Court of Mississippi.

inducements are a losing proposition. Their attitude is expressed in a reply to an inquiry concerning inducements sent out by the National Association of Municipal Officers:[20] "Up to the present the local government has taken the position that any enterprise without financial backing enough to enable it to move to a good town, might be undesirable and may, if improperly financed, go on the rocks and leave its workers subjects for relief. In plainer words, if you can't pay your railroad fare, stay where you are, and if you do come, be prepared to pay your share of the cost of local government." Many municipalities, however, are most undiscriminating in their deliberation concerning these matters.

It should be said for the industrial-development program of Mississippi that the fact that new industries may not always be desirable is expressly recognized. The state industrial commission is instructed to pass upon the desirability of special inducements and is instructed to consider most of the factors which the speaker has here outlined.

It should be observed also that tax concessions and other inducements are at the expense of taxpayers who do not receive them. In some cases they may be at the expense of those who compete directly or indirectly with the recipients of favors. In any event they are at the expense of the general taxpayer—the homeowner, wage-earner, merchant, professional men and, to a lesser extent, the farmer. These people may all stand to gain in the long run by the industrial development which the inducements seek to foster. At all events these taxpayers are the ones who meet the immediate cost of the concessions to industry.

Are Exemptions and Other Special Inducements Desirable from the Social Point of View?

Is it desirable from the point of view of the nation that considerable industry develop in the South? Is it desirable from the point of view of the South? If the answer to both questions is "yes", then is it desirable that industry be promoted in the South at the immediate expense of southern taxpayers not included in the concessions? Many would conclude that where industry is desirable and warranted it will develop on its own account and without special favors. However, our national protective tariff system was not founded upon any such conclusion.

From the social point of view it can be said categorically that tax concessions and other special inducements extended to industries by specific municipalities and states are very undesirable. Concessions and inducements might conceivably be supported by the infant industry argument but industry has had no trouble in getting started

[20] *Tax Exemption*, p. 2.

in this country where the territory was well adapted to its growth. Exemption tends to provoke retaliation and further exemption in an unending cycle. Migration of industry is likely to leave much human disaster in its trail since labor cannot in many cases follow the factory. Finally, exemptions to particular property owners are demoralizing to those who continue to pay taxes.

Preventing Tax Concessions and Migration

It is one thing to recognize the non-social character of tax concessions to industry and quite another to prevent them. As long as the existing policy may be beneficial to particular municipalities or even so long as it appears so to large numbers of people in those municipalities special concessions are likely to persist. Something might be done to prevent them by reciprocal agreements among the states but this would be difficult to arrange and only partially effective. What is needed apparently is a sort of N. R. A. code among municipalities. Within a given state some municipalities might be protected against the chiseling of others by giving the municipality from which a factory moves a right of action against one which has offered illegal inducement. Possibly industries might be compelled to assume more of the overhead cost of moving, such as some of the waste of unemployment created in the process. Unemployment compensation is a step in that direction, but in only a few states is it correlated directly with the conduct of a particular industry. Special land taxes as a means of shifting the burden of the tax system from industry to landlord may be worth considering, on the assumption that land taxes are not shifted, tenant industries would feel no urge to move out because of taxes imposed upon landlords.

Freeing State and Local Tax Systems from Pressure

State tax systems are in many ways limited and cramped by the factor of interstate competition. This is an important difficulty which attends a decentralized political system in the midst of a centralized economic one. Escape from the difficulty might be found in a further centralization of political functions, in the subvention system, in the sharing of centrally collected taxes and in the use of federal credits (such as those now used in the case of death taxes and payroll taxes for unemployment compensation). None of these escapes is free from difficulty and all have their advantages. Progress along any one of these fronts is supported by the evidence concerning competition for the relocation of industry. Progress in these directions is slow, however. Meanwhile, it may be in order to repeat what has been said many times, here and elsewhere: the importance of special concessions and inducements as states can offer to industry and of legislation opposed by industry as "hostile"

is quite frequently exaggerated. States and municipalities can still exercise considerable independence in legislation affecting industry without prejudicing their industrial future. There seems to be a conspiracy of factors and events which make for the elimination of state and local financial independence. Migration and threatened migration of industry is one of these factors. Some independence still remains, however, and it should not be sacrificed needlessly upon the altar of industrial promotion.

CHAIRMAN EDMONDS: This very interesting paper is now before us for discussion. Originally it was to have been opened, according to the program, by Dr. Leonard P. Fox, of the Pennsylvania State Chamber of Commerce, but in his absence we are to have the privilege of listening to Mr. Clarence L. Turner of Philadelphia, who is one of Leo Mattersdorf's accountants and not one of Henry Long's accountants.

CLARENCE L. TURNER (Pennsylvania): Mr. Chairman and Members of the Conference: Dr. Fox regrets very much that he was unable to come to the conference. He told me on Saturday morning—I left on Sunday—that due to circumstances beyond his control he couldn't be here.

I am sure I am a very poor pinch-hitter for Dr. Fox, because he is more familiar with the subject under discussion than I am. All I can do is to read his paper.

I think that Dr. Groves should be congratulated upon the scope he has covered in his paper. He does not leave very much to be covered.

THE EFFECT OF TAX DIFFERENTIALS AND TAX EXEMPTION UPON THE RE-LOCATION OF INDUSTRY

DISCUSSION BY LEONARD P. FOX
Pennsylvania State Chamber of Commerce.

Dr. Groves' expert and challenging exploration of this subject opens up several interesting lines of discussion.

Let's consider for a moment why state government costs are of increasing importance to industry today. Since 1925 there has been a marked change in the relative growth of state and local governmental expenditures. Net local expenditures rose from $5,584 million in 1925 to $7,217 million in 1930, and then tapered off to $5,880 million in 1936. Net state expenditures rose from $1,443 million in 1925 to $2,143 million in 1930, and reached a peak of $2,639 million in 1936. For the four years ended in 1936, local expenditures aver-

aged less than in 1925; but by 1936 the volume of state expenditures had expanded nearly 100 per cent over the 1925 figure.

In Pennsylvania where state tax collections have increased 150 per cent in volume since 1934-35, the state tax bill of industrial corporations often equals their local bill. Exceptions to this rule are corporations having a small capital investment or a low ratio of profit to capital.

State taxes attain added importance for two other reasons. Heavy state levies are likely to be the spearhead of a legislative program that business regards as hostile and unwarranted. The result is that the entire policy of the state towards business is appraised in terms of its state tax burden.

Business is more complacent towards local taxation, because the rates vary in different parts of the state, and a new industry or branch can shop around for the most favorable local tax situation, coincident with other conditions that the industry requires. Moreover, both existing and new industries find a large measure of protection against excessive local tax rates and assessments in the fact that they would equally affect thousands of individual property holders, as well as the comparatively small number of industrial concerns. No similar safeguard operates in the case of state taxes upon industry.

As Dr. Groves points out, the starting of new industries and the establishment of branch plants of existing enterprises are the dominant types of industrial development. Relocation of migrating plants is probably a minor factor in industrial growth.

Permit us to cite a few examples of these and other industrial developments and relate them to Pennsylvania's policy of exempting manufacturing corporations from the capital stock tax of five mills on so much of their capital as was necessarily and exclusively used in the manufacturing process. This policy of encouraging manufacturing in Pennsylvania prevailed from 1885 to 1935. Our examples are taken from some correspondence in 1925 with the Pennsylvania State Chamber of Commerce relative to the proposed abandonment of the policy in that year.

A nationally known publishing company wrote as follows about the manufacturers' tax exemption:

> "We may quote one recent instance in which this company happened to have an interest, in which a newly organized manufacturing corporation, with a capital investment of over $5,000,000 and which employs a large number of people, was after considerable discussion, and notwithstanding liberal concessions offered in the matter of the price of land, etc., presented by another state, finally located at Lock Haven, Pennsylvania, because of the greater feeling of (tax) security in so doing. This instance is merely typical of a number with which we have been acquainted."

From a plate glass company operating in a number of states came this statement:

"Our own case is in point. Our company has quite recently authorized the erection of a plant in this state which will cost between five and six millions of dollars. One of the chief factors in finally selecting Pennsylvania as the location for that plant was the tax law favorable to manufacturers. Other factors were about balanced. The future developments of the company will call for the expenditure of large sums of money for plant extension, and an unfavorable tax law in Pennsylvania will unquestionably lose such industry for this state."

A chain and forging company declared:

"As a foreign corporation we were attracted to build a plant in this state and make it our chief manufacturing center, due to the fact that a foreign corporation by paying a bonus on the capital employed within the state was free, under the law, from any further tax on its capital. For this reason we practically abandoned our manufacturing activities in Ohio and West Virginia and have centered all of our efforts in Pennsylvania. . . ."

From a paper ware company:

"An important reason for moving our manufacturing business from New York to Easton, Pa., some four years ago, was the exemption granted manufacturing corporations. The Easton Board of Trade came to New York and convinced us that all the state of Pennsylvania asked us to do was to provide employment in the state. We are now disbursing several hundred thousand dollars a year to working people in this state, which would not otherwise have been disbursed had it not been for the above representation."

A type manufacturing company went on record as follows:

"This company manufactures typesetting and typecasting machinery, with a distribution all over the world. Our sales within the state of Pennsylvania are not as large in volume as sales in foreign countries or in certain other states of the Union. There is no reason why our manufacturing should be done within the state of Pennsylvania other than the heretofore favorable attitude of the state government toward manufacturing institutions. We *were led to* establish our manufacturing in Pennsylvania through the representations of *commercial* bodies, who pointed out the exemption of manufacturing institutions within the state of Pennsylvania from burdensome taxes."

The manufacturers' tax exemption survived the attack of 1925 and was not abolished until ten years later, when our commonwealth faced the necessity of financing unemployment relief on a pay-as-you-go basis.

Although recent studies, as Dr. Groves observes, show no positive correlation between tax differentials and industrial development, such studies may have erred in their choice of states for the test of correlation. For example, one such study compares tax differentials and industrial growth in nine selected states, from 1922 to 1929 and 1929 to 1935. This comparison covers such seasoned industrial states as Pennsylvania, New York and Massachusetts, and the younger industrial states of Michigan, Illinois, Ohio, Wisconsin, Indiana and Minnesota.

In its recent monograph on "Growth of American Manufacturing Areas," the Pittsburgh Bureau of Business Research discloses significant relationships between the rates of growth in manufacturing employment and the location of these areas. Of the ten areas that gained the most between 1869 and 1899, seven were midwestern areas, two were Pacific Coast areas, and one was located in the South. Areas holding intermediate or lower growth ratings also confirmed the tendency "for the rate of gain to rise the farther the area is located to the west of New England."

A like relationship between rate of growth and the location of manufacturing areas marked the period 1899 to 1929. In this period the areas which ranked in the upper third of the list in manufacturing employment were with one exception located in the East North Central or Pacific Coast states. Areas in the middle third of the list tended to concentrate in the eastern part of the East North Central district and in the Middle Atlantic states. The lower third was occupied by areas in New England or the eastern part of the Middle Atlantic section.

According to Glenn E. McLaughlin, the author of the monograph:

> "The relationship between rate of growth and location of area probably results primarily from the fact that the population settlement in this country proceeded from east to west. During the second half of the period, another factor of probably greater importance in accounting for the large gains in manufacturing employment in areas located in the East North Central section was the rapid expansion in the automobile industry and related industries. It happened that these industries were for the most part concentrated in that section of the country."

Since 1800 the center of manufacturing has shifted westward, roughly paralleling but lagging behind the westward movement of the center of population. The extension of manufacturing opera-

tions westward from the Atlantic seaboard sharply increased the gains in manufacturing activity in midwestern and western states. Hence the rate of manufacturing growth during the latter part of the 19th century and the first part of the 20th century was much greater in the comparatively new regions than in the older industrial areas of the Northeast.

These facts suggest that in studying the relationship between industrial growth and tax differentials, we should compare areas for the same stage of economic development rather than for the same period of time. No tax differential can possibly restore youth to an area that has reached industrial maturity or passed it.

Consider Pittsburgh, perhaps the youngest industrial area in Pennsylvania, but mature nonetheless. The rate of gain in value added by manufacture was somewhat greater in the Pittsburgh area from 1869 to 1929 than in all of the country's major industrial areas combined; very much greater in the first half of the period, and considerably less in the second half. Rising in national importance from 1869 to 1899, the Pittsburgh district made greatest gains in the 90's, coincident with the early years of the commonwealth's liberal tax treatment of manufacturers.

Manufacturing employment likewise grew most rapidly in the Pittsburgh area during the 80's and 90's, although the rate of growth was still high in 1904. The peak was reached in 1918. Since 1923 the trend has been downward.

Pennsylvania recently discarded its favorable state tax differential as an encouragement to industry. Too little time has elapsed since 1935 to appraise this reversal of our state tax policy. Proponents of the new order foresee no adverse results. Balancing new industries that have come into our state (excluding Philadelphia and Pittsburgh) against those that have left, they cite a new gain of 74 establishments and 4,600 workers in a period of 3½ years. On the other hand, such gain is more than wiped out by the decision of the American Viscose Company to locate a large new plant (employing 7,500 people) in Virginia instead of in Pennsylvania, on account of the heavy state tax burden in our commonwealth.

On the basis of this and other evidence, we conclude that some revision is due perhaps in the weighting of industrial location factors as reported in the survey of the National Electric Light Association and the policyholders service bureau of the Metropolitan Life Insurance Company, covering the years 1926 and 1927. Since that time, for example, the slice that state taxation takes out of income produced in the United States has at least doubled.

By preferential tax treatment of industry a state hopes to encourage economic activity that will produce large payrolls, increase

property values, and otherwise add to the tax resources of government.

Having more varied tax resources than the municipality, the state can better afford to grant a preferential tax status to a given line of business. The municipality is essentially limited to the general property tax, and any extensive immunity therefrom must result in heavier burdens upon non-exempt property owners and sacrifice one of the main objectives of the state's preferential treatment of industry.

Apart from tax concessions, some municipalities have gone to absurd extremes in the inducements offered to industrial prospects.

Providing a factory building without cost or at a nominal rental, paying the moving expenses of an industry, and extending industrial loans which a bank would not consider — these are subsidies which make the community a partner in the industry, but without any voting control therein. The subsidies are sometimes granted under the pressure of a local campaign for more industries, and consequently are not based on a calm evaluation of the prospect's character, capacity and business opportunities. Little wonder that such subsidies have often given communities chronic headaches instead of industrial gains. The time is ripe for commercial and other promotional organizations to recognize this fact and shape their practices accordingly. Otherwise they should blow out the lamp of experience.

Chairman Edmonds: These two interesting papers are now before you for general discussion. Is there anyone who desires the floor to ask a question or to present an argument?

I think I ought to contribute a personal experience of my own. The treasurer of the American Viscose Company told me that one of the reasons they moved down to Virginia was that when he called upon Mr. Morrissett he found such a charming and fair tax commissioner. I think Mr. Morrissett is an asset to the state of Virginia, and perhaps suggest that he has learned what Commissioner Stone emphasized so strongly on Tuesday night.

Is there any other discussion?

If not, we will turn to the second number on the program, which is the "Report of the Committee of the National Tax Association on Federal Taxation of Corporations." Speaking as a member of that committee, I would like to say that all of the members of that committee unite in their tribute to Dr. Robert Murray Haig for the leadership, the interest, the initiative, and the zeal with which he has prosecuted this inquiry.

It gives me great pleasure to present Dr. Haig, the chairman of the committee.

PRELIMINARY REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON FEDERAL TAXATION OF CORPORATIONS

ARTHUR ANDERSEN, R. C. BECKETT, GERHARD COLM, FRANKLIN S. EDMONDS, MARK GRAVES, M. SLADE KENDRICK, ARTHUR H. KENT, GODFREY N. NELSON, THOMAS REED POWELL, FRANK E. SEIDMAN, WILLIAM A. SUTHERLAND, ROBERT MURRAY HAIG, *chairman*

I. Introduction

The resolution requesting the establishment of this committee was adopted at Baltimore in November, 1937, and read as follows: [1]

> Resolved, that the thirtieth annual National Tax Conference request the National Tax Association to appoint a committee to investigate and report at the next annual conference upon the federal taxation of corporations, including the taxation of undistributed corporate profits.

It appears from the record of the proceedings of that conference [2] that the proposal to establish our committee originated in the course of a debate on the merits of the federal undistributed profits tax of 1936. The debate centered about a resolution, introduced by the committee on resolutions but not adopted by the conference, which called for certain specific modifications "if the undistributed profits tax is to be continued." [3] The view which ultimately prevailed was that the conference should adopt no resolution "opposing the current legislation and current tax practice of the federal government without a thorough and constructive analysis." [4] Apparently what is desired from our committee is, first, an analysis of the numerous and important issues involved in the problem faced by the federal government in taxing corporations, second, a critical review and appraisal of the results of the policies actually followed in the past, third, a formulation of possible alternative future courses of action and finally an expression of judgment regarding the relative desirability of these possible courses.

This is a large assignment and one that is in no sense fulfilled by the report now submitted. If it is the desire of the association that

[1] National Tax Association, *Proceedings of Thirtieth National Conference,* 1937, p. 527.

[2] Pages 514-528.

[3] Page 514.

[4] Page 515.

the committee continue its labors during the coming year, an earnest effort will be made to prepare and submit a definitive report to the next conference. The report submitted today should be considered preliminary and tentative in character, designed primarily to formulate issues and to stimulate discussion. Such discussion will be helpful to the members of the committee in formulating its final report.

The membership of our committee was finally determined late in February, 1938. Three meetings have been held, the first in New York City, on June 17th with seven members present, the second in New York City, also, on September 16th and 17th with nine members present, and the third in Detroit on October 26th with eight members present. Before its first meeting the revenue act of 1938 had already become the law of the land. This new act, while retaining the principle of the 1936 undivided profits tax, reduced the rates to relatively insignificant figures. Incidentally, it incorporated most of the specific amendments which had been included in the suggested resolution that failed of passage at the Baltimore conference.

Nothing could be more obvious, however, than that the revenue act of 1938 has not finally disposed of the undivided profits tax controversy. Indeed the entire question of federal policy regarding the taxation of corporations remains in the foreground of public discussion. The new revenue act inspired such slight enthusiasm in the President of the United States that he adopted the unusual course of permitting legislation of this character to become law without his formal approval and he promptly expressed his intention to urge its early modification.[5] Moreover the act itself specifies that the taxes on corporations "shall not apply to any taxable year beginning after December 31, 1939."[6] Consequently, fresh legislation must be forthcoming soon, probably at the next session of the congress.

After reviewing this situation and after conferring with the officers of the association, our committee decided at its first meeting to approach its problem in a broad fashion and in terms of fundamentals, even though it was recognized that such a course would preclude the possibility of submitting a final report to this 1938 conference. Nevertheless, in view of the outlook for early legislation, it was considered desirable in this preliminary report to make specific comments on certain points upon which there appeared to be substantial agreement among the committee members.

II. The Evolution of the Federal Taxes on Corporations

Under the direction of one of the members of our committee, Mr. Sutherland, there has been prepared an extended memorandum that

[5] Address of May 27, 1938, *New York Times*, May 28, 1938.

[6] Revenue act of 1938, Sec. 15.

deals with the legislation in this field since the time of the civil war and that sets forth the facts regarding the various federal taxes on corporations in sufficient detail to make clear the significant changes and developments. We publish this document as an appendix to this report.

Since federal action in this field has taken place in the presence of heavy state taxes on corporations and since future federal action is conditioned to an appreciable extent by the character of the action taken by the states, the committee considered it highly desirable that an analysis be made of the course of state taxation of corporations during recent decades, with the object of bringing to light such general trends and tendencies as may be discernible in such legislation. In this connection the committee has been so fortunate as to secure the cooperation of Charles W. Gerstenberg, whose memorandum contributes substantially to our understanding of these conditions which federal plans should take into account.

While the federal tax history of the civil war period foreshadows in an interesting fashion some of our present-day difficulties and some of our recent legislation, these early measures are not the direct lineal ancestors of the present federal corporation taxes. The current chapter really begins with the corporation special excise tax of 1909.[7]

This 1909 law utilized net income indirectly as a measure for determining tax liability and it applied to corporations only. The rate was 1 per cent. Superficially its passage seemed to indicate the acceptance of the notion that an objective impersonal type of business taxation should form a part of federal tax policy. However this action in 1909 may be interpreted quite differently; instead of being considered a definite decision in favor of this type of business taxation, the corporation excise law may be explained as a mere temporary expedient for putting immediately into effect as much in the way of a federal income tax as it was legally possible to impose at the time. It may be recalled that, even before passing this corporate excise tax, congress had adopted the proposal for the sixteenth amendment and had started it on its way for approval by the states. Moreover in 1913, only a few months after the approval of that amendment, congress promptly repealed the 1909 act and passed a general income tax, effective back to the time when the power under the sixteenth amendment became available. This revenue act of 1913 used the corporation tax primarily as a convenient device for collecting at the source a portion of the tax on persons. Such facts as these suggest the inference that prior to the world war the conception of an objective, impersonal federal income tax on business or corporate income had not won full acceptance in the public mind.

[7] Act of August 5, 1909.

In any case the revenue act of 1913 imposed a tax on corporate income, again at the rate of only 1 per cent, and permitted a credit in the return of the individual shareholders to the extent of the full 1 per cent with respect to all corporate income distributed as dividends. In other words, for corporations which promptly distributed all their earnings to individual shareholders, there was, in substantial effect, no corporation tax.[8] There was, indeed, under the 1913 and 1916 acts a minor differentiation in favor of the corporate form, in that the dividends subjected to individual surtax rates represented corporate earnings after deduction of the corporation tax while the distributive shares of partnership profits and the earnings of individuals were subjected to the surtax rates, without deduction of the normal rate paid on the profits.

Moreover, this general policy with reference to the taxation of corporate income continued in spite of increases in rates until just before we became actually involved in the war. Then the situation became complicated by the special taxes on excess profits and on capital stock. Here it is interesting to recall that in its earlier versions the excess profits tax was not distinctively and exclusively a corporation tax but that it was applicable to certain unincorporated business profits and professional earnings of individuals as well.[9] The narrowing of the scope of tax so that it applied only to corporations may be ascribable not to a feeling that it was theoretically desirable for the excess profits of corporations only to be taxed but rather to the conviction, grounded in practical experience, that, because of the administrative difficulties with the broader base, the game was not worth the candle. The capital stock tax, a true corporate excise, was first imposed in 1917 but at a rate so light as to give it slight fiscal significance.

During the war the credit against the normal tax granted to dividends from corporations subject to the income tax became entangled with the similar credit granted to interest on certain issues of Liberty Bonds and the rate as well as graduated form of the normal taxes imposed after 1917 were undoubtedly influenced by the treasury's desire to purchase an improved market standing for its bonds by an increase in credit against the normal tax. Certainly the fairly precise equivalent between the rate of the corporation tax and the dividend credit disappeared at this time, never to return, and the end of the war found the corporations not only saddled with an in-

[8] It should be pointed out, moreover, that even under these early statutes complete provision was not made for a reduction of the tax on the corporation to take account of dividends received by persons who, because of small size of their incomes, were not subject to the normal tax.

[9] The act of March 3, 1917 applied to corporations and partnerships and the act of October 3, 1917 applied to corporations, partnerships and individuals. The third excess profits tax, the act of February 24, 1919, was imposed solely on corporations.

come tax which could not be even theoretically cancelled by a full distribution of profits but also saddled with the excess profits tax and the capital stock tax, neither of which carried any crediting provision for the benefit of the shareholder.

The transformation of the income tax on corporations into a something distinctly more than a convenient device for collecting the personal income tax at the source became more marked when in 1922 the repeal of the excess profits tax was accompanied by an increase in the corporation income tax rate with no corresponding increase in the normal rate on individuals which could be credited against dividends received. It may be that the corporations were so eager for the repeal of the hated excess profits tax that they gladly accepted a flat rate business tax on their ordinary income as a part of normal peace time policy. Certainly from this time forward the corporation income tax could no longer be interpreted as essentially a prepayment on behalf of shareholders that could be cancelled by a full and prompt distribution of dividends. We now had in force a corporation income tax, a substantial portion of which could be described as an objective, impersonal levy on profits earned under this particular form of ownership organization. At least, it was now generally true that profits to individuals from unincorporated business were taxed less heavily than profits to individuals from corporations which distributed their profits promptly and completely in the form of dividends.

However, the disparity described above, between the rate of the corporation income tax and the rate at which individuals could take credit in the personal returns for dividends received, need not necessarily be thought of as exclusively an objective, impersonal tax on business profits. Two other explanations are possible. In the first place it may be argued that some disparity was justifiable on the ground that, since most corporations did not distribute their profits fully and promptly, a somewhat higher rate on corporate profits generally was called for to offset this privilege, not open to unincorporated business, of holding profits undistributed and consequently free from the surtax rates applying to individuals for the period they remained undistributed or unrealized in the form of capital gains. In the second place, the disparity may be explained, not as a true business tax, but as a special tax for the privilege of operating under the corporate form, a tax which other forms of business were not asked to pay because they did not avail themselves of the special privilege.

Whatever the interpretation, it is clear that, during the post-war, pre-depression period, the rate-structure of the federal income tax reveals a substantial disparity between the rate of the tax on the dollar of corporate net income and the rate of the credit allowed on the dollar of dividends received by individuals. This disparity reached a peak for this period in the years 1926 and 1927 when the

rate on corporate income was 13½ per cent, while the maximum normal rate which an individual shareholder could use as a credit for dividends received was only 5 per cent. Even if this disparity is not properly interpreted as a distinct objective tax on corporate profits, it certainly served to set the stage for the developments of the depression period which cannot be interpreted in any other way. Today we have federal taxation of corporations in a very real sense, not merely the collection of a personal income tax at the corporate source, and the only possible debate relates to the date at which we began to have such federal taxation of corporations.

III. Recent Developments

When the impact of the depression on the federal finances began to be seriously felt, important changes in the federal taxation of corporations came in rapid succession.

Even before the elections of 1932 the rate on the income of corporations was raised to 13¾ per cent, a height never before reached, although the disparity between this corporate rate and the rate of credit for dividends in the individual returns was substantially reduced from the previous figure.[10] At this time also the policy of imposing a higher rate in the case of consolidated returns was introduced.[11]

In 1933, a 5 per cent excise tax was imposed on the receipt of dividends by any person other than a domestic corporation,[12] the capital stock tax was reintroduced, accompanied by a peculiar use of the excess profits tax as a device for preventing the undervaluation of capital stock,[13] the carry-over of losses was abolished[14] and the differential in the rate against consolidated returns was increased.[15]

In 1934, the use of consolidated returns was abolished except in the case of the railroads and for them the differential rate was raised to 2 per cent.[16] Moreover the normal rate on individuals was reduced to a flat 4 per cent, establishing the disparity between the corporation rate and the individual credit at a new high mark of 9¾ per cent.

At this juncture, the taxation of corporations engaged the attention of the chief executive. On the 19th of June, 1935, the President

[10] The normal rate on individual income was increased from 1½–3–5 per cent to 4–8 per cent. Revenue act of 1932, Sec. 11.

[11] *Ibid.*, Sec. 141 (b).

[12] National Industrial Recovery Act of June 16, 1933, Sec. 213.

[13] *Ibid.*, Sec. 215.

[14] *Ibid.*, Sec. 218 (a).

[15] *Ibid.*, Sec. 218 (e).

[16] Revenue Act of 1934, Sections 11, 13.

transmitted to the congress a message [17] devoted in large part to a discussion of the problem of the taxation of corporations. Since this message was offered as a considered pronouncement of desirable federal policy, an examination of some of its assertions and its assumptions may serve to illuminate the state of thought and opinion in official circles regarding the problem assigned to this committee.

Early in the message the President stated flatly—

> "Our revenue laws have operated in many ways to the unfair advantage of the few, and they have done little to prevent an unjust concentration of wealth and economic power."

He proceeded to advance definite proposals for

> "an inheritance, succession, and legacy tax in respect to all very large amounts received by any one legatee or beneficiary . . . " and "a definite increase in the taxes now levied upon very great individual incomes."

With respect to the corporation income tax, he wrote:

> "The advantages and the protections conferred upon corporations by government increase in value as the size of the corporation increases. Some of these advantages are granted by the state which conferred a charter upon the corporation; others are granted by other states, which, as a matter of grace, allow the corporation to do local business within its borders. But perhaps the most important advantages, such as the carrying on of business between two or more states, are derived through the federal government—great corporations are protected in a considerable measure from the taxing power and the regulatory power of the states by virtue of the interstate character of their business. As the profit to such a corporation increases, so the value of the advantages and protections increases."

Turning to the small corporation, he called attention to the following considerations:

> "Furthermore, the drain of the depression upon the reserves of business puts a disproportionate strain upon the modestly capitalized small enterprise. Without such small enterprises our competitive economic society would cease. Size begets monopoly. Moreover, in the aggregate these little businesses furnish the indispensable local basis for those nation-wide markets which alone can increase the success of our mass-production industries. Today our small corporations are fighting not only for their own local well being but for that fairly distributed national prosperity which makes large-scale enterprise possible."

[17] Hearings before the Committee on Ways and Means, 74th Congress, 1st Session, Washington, 1935, pp. 2-4.

On the basis of this analysis he announced his conclusion:

> "It seems only equitable, therefore, to adjust our tax system in accordance with economic capacity, advantage and fact. The smaller corporations should not carry burdens beyond their powers; the vast concentrations of capital should be ready to carry burdens commensurate with their powers and their advantages.
>
> "We have established the principle of graduated taxation in respect to personal incomes, gifts and estates. We should apply the same principle to corporations. Today the smallest corporation pays the same rate on its net profits as the corporation which is a thousand times its size.
>
> "I, therefore, recommend the substitution of a corporation income tax graduated according to the size of corporation income in place of the present uniform corporation tax. . . ."

Before closing, he incidentally remarked that—

> "Ultimately we should seek through taxation the simplification of our corporate structures through the elimination of unnecessary holding companies in all lines of business. We should likewise discourage unwieldy and unnecessary corporate surpluses."

It seems proper to point out that as a demonstration of desirability of applying to corporate incomes a scale of rates graduated upward as the size of the corporate income increases, the message leaves much to be desired.

In the first place the assertions that corporations doing an interstate business derive advantages from the federal government and that "as the profit to such a corporation increases, so the value of its advantages and protection increases" may form the foundation for a conclusion that a special federal tax on interstate business is indicated and that this tax should be uniformly commensurate with profits. However they do not support a conclusion that the federal government should tax all corporate profits by means of a progressive scale which increases the tax more rapidly than the profit of the corporation increases.

In the second place the unsupported assertion that the depression has placed "a disproportionate" strain on small enterprise and the statement that it is important to preserve small businesses do not necessarily lead to the conclusion that under a flat rate, small enterprises were taxed "beyond their powers" and that large corporations were not called upon to "carry burdens commensurate with their advantages." After all, the tax under discussion is a net income tax which, except as this end may be prevented by arbitrary definitions of the tax base, applies only to corporations which make money.

Finally to contend that, since progressive rates are acceptable in taxing personal incomes, gifts and estates, they should also be applied to corporate income is to resort to an argument by analogy not likely to carry conviction to anyone who is familiar with the theoretical foundations for progression in the fields of personal taxation and death duties.

Particularly interesting from the point of view of one who attempts to trace the development of the rationale of federal policy in this field is the complete absence in this message of mention of the relationship of the corporate income tax to the personal income tax. The corporation tax is here discussed as though it were an impersonal objective tax existing in a vacuum. The credit provisions for dividends are entirely ignored and the conception of the corporation as a legal entity interposed between the business and its real owners is given no consideration whatsoever. This is especially remarkable in view of the fact that in the President's message of March 3, 1936, to be discussed later, the approach is entirely different, the position there being that the entire problem would be solved if corporations were forced to distribute their earnings promptly and completely.

The response of the congress to this message was the revenue act of August 30, 1935, which imposed a progressive rate scale on the incomes of corporations which ranged from 12½ to 15 per cent, a more moderate scale than the President had recommended. The new scale was to apply only in the case of taxable years beginning after December 31, 1935.[18] This act also reduced the deduction which a corporation might make on dividends received from 100 to 90 per cent.[19]

However, the 1935 progressive rate scale on corporate income was destined never to be applied because before any returns were due for the taxable years affected, a fresh revenue act, that of 1936, had been enacted. This revenue act of 1936 carried the now-famous undistributed profits tax and was prompted by a presidential message, transmitted March 3, 1936. The portions of this message that related to the federal taxation of corporations read as follows:

> "I invite your attention, . . . to a form of tax which would accomplish an important tax reform, remove two major inequalities in our tax system, and stop 'leaks' in present surtaxes.
>
> "Extended study of methods of improving present taxes on income from business warrants the consideration of changes to provide a fairer distribution of the tax load among all the beneficial owners of business profits whether derived from unincor-

[18] Revenue act of 1935, Sec. 107.

[19] *Ibid.*, Sec. 102 (b).

porated enterprises or from incorporated businesses and whether distributed to the real owners as earned or withheld from them. The existing difference between corporate taxes and those imposed on owners of unincorporated businesses renders incorporation of small businesses difficult or impossible.

"The accumulation of surplus in corporations controlled by taxpayers with large incomes is encouraged by the present freedom of undistributed corporate income from surtaxes. Since stockholders are the beneficial owners of both distributed and undistributed corporate income, the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or withheld from the beneficial owners. As the law now stands our corporate taxes dip too deeply into the shares of corporate earnings going to stockholders who need the disbursement of dividends, while the shares of stockholders who can afford to leave earnings undistributed escape current surtaxes altogether.

"This method of evading existing surtaxes constitutes a problem as old as the income tax law itself. Repeated attempts by the congress to prevent this form of evasion has not been successful. The evil has been a growing one. It has now reached disturbing proportions from the standpoint of the inequality it represents and of its serious effect on the federal revenue. Thus the treasury estimates that, during the calendar year 1936, over 4½ billion dollars of corporate income will be withheld from stockholders. If this undistributed income were distributed, it would be added to the income of stockholders and there taxed as is other personal income. But, as matters now stand, it will be withheld from stockholders by those in control of these corporations. In one year alone, the government will be deprived of revenues amounting to over $1,300,000,000.

"A proper tax on corporate income (including dividends from other corporations), which is not distributed as earned, would correct the serious two-fold inequality in our taxes on business profits if accompanied by a repeal of the present corporate income tax, the capital-stock tax, the related excess-profits tax, and the present exemption of dividends from the normal tax on individual incomes. The rate on undistributed corporate income should be graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of stockholders.

"Such a revision of our corporate taxes would effect great simplification in tax procedure, in corporate accounting, and in the understanding of the whole subject by the citizens of the nation. It would constitute distinct progress in tax reform."

It is interesting to compare this message of March 3, 1936, with the President's earlier message. In June, 1935, he urged that "the advantages and protections conferred upon corporations by government" justify, on the benefit basis, the imposition of an objective impersonal tax on corporations "graduated according to the size of corporation income." This step would "adjust our tax system in accordance with economic capacity, advantage and fact." He made no mention whatsoever of the individual shareholders in the corporations or the repercussions of his proposals upon their economic position. His proposals, somewhat modified, were promptly enacted into law.

Then, in March, 1936, before a single return has been filed under the new law incorporating the reform urged nine months before, the President proposes a new reform, formulated exclusively from the individual point of view. He tears aside the corporate veil. All of the objective, impersonal taxes on corporations — the capital-stock and excess-profits taxes and the new-born progressive tax on the income of corporations—should be abolished. On corporations which fully and promptly distribute their earnings to their shareholders, the federal government should levy no taxes whatsoever. "A fair distribution of the tax load among all the beneficial owners of business profits whether derived from unincorporated enterprises or from incorporated business and whether distributed to the real owners or withheld from them" is now announced as the sole objective of federal policy in this field.

It is important always to remember that every substantial change in the federal revenue laws affecting corporations inevitably places on the business community not only the substantial burden of mastering the meaning and effect of the legislation but also the even greater burden of adjusting business plans and arrangements in the light of the new statute. The problem of the federal taxation of corporations is sufficiently important to command painstaking and serious consideration. Indeed it would be difficult to name a problem in the entire range of public policy which, because of the importance of the public and private interests affected and because of the complicated character of the repercussions to be anticipated from the change, calls more clearly for careful, patient exploration and analysis of the type we have come to expect from bodies such as the British Royal Commissions. Such exploration and analysis were lacking in 1935 and 1936.

The declaration, in the President's 1936 message, that "the aim, as a matter of fundamental equity, should be to seek equality of tax burden on all corporate income whether distributed or not" is one which commands widespread assent. But that this should be the sole aim in the federal taxation of corporations is not so clear. Furthermore, due weight must be given to the formidable technical problems—legal, economic and administrative—encountered in any

attempt to achieve this aim. It soon developed that the President's suggestions, including the abolition of existing corporation taxes and the individual credit for dividends received, coupled with a "rate on undistributed corporate income . . . graduated and so fixed as to yield approximately the same revenue as would be yielded if corporate profits were distributed and taxed in the hands of stockholders," were not easy to translate into a definite legislative bill. It became obvious, for example, a rate scale calculated to produce, when applied to the undistributed profits of corporations in general, approximately the same revenue to the government as if distributed, could not possibly be expected to impose on individual shareholders a burden in an exact sense commensurate with the taxes they would have paid had they received all corporate earnings as dividends.

The law which the congress passed June 22, 1936, in response to the President's March message, departed substantially from his recommendations. The individual credit against normal tax was, it is true, abolished, and the corporate credit for dividends received was reduced from 90 to 85 per cent.[20] Moreover a new tax was imposed on undistributed profits with rates ranging from 7 per cent to 27 per cent on successive blocks of undistributed net income whose dimensions were determined by the relationship of undistributed to the total "adjusted net income."[21] But this action was not accompanied by the repeal of the capital-stock and excess-profits taxes nor by the abolition of the corporation income tax. Indeed the last-named tax was continued in the general form adopted in response to the 1935 message but with a scale graduated from 8 to 15 per cent according to the size of the income.[22]

It was this 1936 legislation which roused the storm of protest which raged so recently that there is no need to recall it here, and which was directly responsible for the establishment of our committee. In a later section the committee's specific criticisms of some of the provisions of the undistributed profits tax are submitted. Suffice it to say at this point that the Congress found it advisable to bow to the storm. The revenue act of May 16, 1938 reduced to insignificance the undistributed profits tax feature of the 1936 law for taxable years beginning after December 31, 1937,[23] and adopted a temporary plan of corporation taxation, the general features of which will now be outlined.

Under the 1938 law the capital-stock and excess-profits taxes remain, with no change in rate.[24] Dividends received by individuals

[20] Revenue act of 1936, Sections 25 and 26 (b).

[21] *Ibid.*, Sec. 14.

[22] *Ibid.*, Sec. 13 (b).

[23] Revenue act of 1938, Sec. 1.

[24] *Ibid.*, Sections 601, 602.

continue to be subject to the full normal and surtax rates.[25] Dividends received by corporations may be deducted at the previous rate of 85 per cent.[26] The penalty surtax on corporations improperly accumulating surplus now stands at 25–35 per cent.[27] In the case of personal holding companies, rates of 65–75 per cent are imposed on net income undistributed.[28] The general corporation income tax rate is now 16½ per cent [29] for corporations with more than $25,000 net income; for corporations with less than that amount of net income the rates range from 12½ to 16 per cent.[30] What remains of the undistributed profits tax is now applicable only to corporations with incomes of over $25,000. For corporations with incomes in excess of this amount a tax is imposed on undistributed profits but the maximum rate is only 2½ per cent. In other words, under the present law a prosperous corporation which distributes all of its earnings is taxed 16½ per cent, while a corporation which distributes none of its earnings is taxed at most 19 per cent.[31]

In this brief sketch which attempts to bring into clear relief the main trends in the federal taxation of corporations much has been omitted. No mention is made, for example, of the federal legislation of 1914 imposing federal taxes on the issuance and the transfer of stock. Furthermore nothing is said of the interesting attempts to prevent the deliberate use of the corporate form to avoid the payment of the individual surtaxes or of the special legislation affecting personal holding companies. Finally no account is given of the fluctuating policy with respect to the taxation of capital gains, which forms an essential part of any truly comprehensive description of the evolution of policy in the field under review.

The following table summarizes the variations since 1913 between the corporate income tax rate and the rate available to individuals for use as a credit for dividends received.

IV. The Objectives of Corporation Taxation

In view of the record and the outlook, everyone will agree that a suitable time has arrived to pause and inquire what we want to try to accomplish by means of federal taxes on corporations. As John Stuart Mill long ago observed, "The first object in every practical discussion should be to know what perfection is." Unless there is agreement as to objectives, there can be slight hope of agreement as to detailed methods and specific technique."

[25] *Ibid.*, Sec. 25.
[26] *Ibid.*, Sec. 26.
[27] *Ibid.*, Sec. 102.
[28] *Ibid.*, Title I A.
[29] *Ibid.*, Sec. 13 (c).
[30] *Ibid.*, Sec. 14 (c).
[31] *Ibid.*, Sec. 13.

FEDERAL INCOME TAX, RATES ON CORPORATIONS AND NORMAL RATES ON INDIVIDUALS AVAILABLE FOR DIVIDEND CREDIT, 1913–1939 [a]

Revenue act of	Income years	Corporation rates (per cent)	Individual normal rates available for dividend credit (per cent)	Minimum disparity against corporation that distributed profits completely and promptly (per cent)
Oct. 3, 1913	1913–1915	1	1	0
Sept. 8, 1916	1916	2	2	0
As amended Oct. 3, 1917	1917	6	4	2
Feb. 24, 1919	1918	12	6–12	0
	1919–1920	10	4–8	2
Nov. 23, 1921	1921	10	4–8	2
	1922–1923	12½	4–8 [b]	4½
June 2, 1924	1924	12½	2–4–6	6½
Feb. 26, 1926	1925	13	1½–3–5	8
	1926–1927	13½		8½
May 29, 1928	1928	12	1½–3–5	7
	1929	11 [c]	½–2–4 [c]	7
	1930–1931	12	1½–3–5	7
June 6, 1932	1932–1933	13¾	4–8	5¾
May 10, 1934	1934–1935	13¾	4	9¾
June 22, 1936	1936–1937	8–15 [d]	0	8–15
May 16, 1938	1938	12½–16½ [e]	0	12½–16

[a] Compiled from *Statistics of Income for 1934*, Part 1, pp. 112–113, Part 2, pp. 210–211. Individual statutes since that date.

[b] Tax for 1923 reduced 25 per cent by credit or refund under section 1200 (a) of the revenue act of 1924.

[c] Joint Resolution No. 133, approved by the President, December 16, 1929.

[d] Plus rates of 7 to 27 per cent on undistributed profits. The rate scale of 8–15 per cent imposed on the normal income of corporations by the revenue act of 1936 superseded the rate scale of 12½–15 per cent imposed by the revenue act of August 30, 1935 in the case of taxable years beginning after December 31, 1935.

[e] In the case of profits not distributed accruing to corporations with net incomes in excess of $25,000, such undistributed profits are in general subject to an additional rate of 2½ per cent.

At the very outset it may be observed that a substantial part of the heat generated in the course of the recent controversy over federal corporation taxes is clearly ascribable to a conviction in the minds of many persons that, under the guise of changes in the tax laws and under the banner of sound tax reform, our effort has been made to further indirectly certain economic and social ends which, if presented frankly and directly, might not have commanded general approval. Whether well-founded or not, a feeling of fear and

suspicion has arisen lest clever, technical changes in the tax system be disingenuously used to further purposes not frankly disclosed.[32] Without attempting to pass on the question as to the extent to which there may be good ground for such a feeling, the committee desires to voice its regret that the consideration of this difficult problem has been complicated by the presence of this feeling.

It perhaps goes without saying that a fundamental objective of federal corporation taxes is to secure revenue for the public fisc and to accomplish this with due regard to the various general canons of taxation that in the course of the centuries have commended themselves to students of finance. It is only when attention is turned to more specific issues that the troublesome and debatable points arise. The levies on corporations form a part of a congeries of federal taxes that we should strive to raise to the dignity of a system,—unified, consistent and in harmony with prevailing notions of equity and desirable public policy. In such a system what role falls to the taxation of corporations? Moreover it must constantly be borne in mind that whatever may be the role assigned to federal corporation taxes, that role must be played in cooperation with state taxes on the same subjects.

a. The Corporation Tax in Relation to the Personal Income Tax. In the last twenty-five years the progressive personal income tax has become the cornerstone of the federal revenue structure and it promises to continue as such in the years that lie ahead. In preceding sections we have described the manner in which a tax on the net income of corporations has been utilized in the past to collect at source an important part of the tax on personal incomes. We now call attention to the general question: Should a federal tax on corporate net income be used to supplement the personal income tax and to increase its effectiveness? If this be accepted as an objective, should it be the sole aim, a primary aim or an incidental aim?

It is at once evident that the answer to the question as to whether it is desirable to use a tax on corporate income as a part of the mechanism of the personal income tax may depend largely on the character of the personal income tax itself. It is conceivable that the taxable personal income might be so defined as to render superfluous such use of a corporate income tax. At this point the intimate relationship of our problem to the problem of the taxation of capital gains, now under consideration by another committee of this association, becomes apparent.

Without attempting to present a comprehensive theoretical analysis, it may be pointed out that there exist at least two comprehen-

[32] See for example Maurice Wertheim, "The Undistributed Profits Tax," *Harper's Magazine*, February, 1938.

sive and self-consistent concepts of taxable income. Under the first of these, which we may designate the expenditure concept, every individual would be called upon to pay income tax on his spendings during the taxable year. Under the other concept, every individual would be asked to pay on what comes in to his credit,—on the net accretion to his economic strength — during the year. The most significant difference between the two concepts lies in their treatment of savings. The first concept exempts savings, until they are spent and, of course, they may never be spent), while the second concept asks only what net income has been received and does not reduce a man's tax liability because he is able and willing to save a portion of it. Both concepts supply. only approximate measures of true economic income, which, because of its intangible psychical character, is unavailable for use as a practical tax base.

If one assumes that ultimately all savings are spent, the use of either concept over a long period will yield the same aggregate tax base. The accrual concept, however, taxes savings at an earlier point in time than the expenditure concept. If we wait until savings are spent to apply the tax, the treasury loses an advantage equivalent to the interest on the tax on savings for the full period of postponement. Similarly, if two men who have received equal salaries during a taxable year, the one who saves half his salary secures an advantage as compared with the man who does not save, equivalent to interest on the tax on half his income for the period during which he chooses to postpone consumption.[33]

In making the choice between these two concepts as a base for personal income taxation, the decision almost universally has been in favor of some variation of the accrual concept. We have, in general, decided that equity in taxation is better served when burdens are apportioned among us according to what we have been able to accumulate during the year than when they are apportioned according to what we have spent. It may be that in some future day the expenditure concept, with its more lenient treatment of savings, will find favor with our people, but there is no indication that this day is near at hand. If and when it comes the function of the corporation tax as an implement of personal income taxation will disappear.

A solution of the general problem imposed through the adoption of the expenditure concept of income, however desirable that action may seem to some, appears to the committee to be unavailable. Our general policy will probably continue not to exempt from the burden of the income tax, during his period of abstinence, the amounts laid

[33] This example assumes no change of tax rate, whereas to yield the treasury the same support it would be necessary to increase the tax rate under the expenditure concept if there were any net savings in the community as a whole. Possible repercussions on interest rates are also pertinent.

aside by the man who is able and willing to save, consequently the problem will remain of devising means for bringing to account the savings which accrue to individuals by virtue of their ownership of shares of corporate stock. Moreover so long as it is our policy to regard savings as a proper part of the income tax base, the problem of taxing capital gains will remain. Our committee was fortunate enough to be able to arrange a joint session with the association's committee on the taxation of capital gains. Realizing that, if this committee should recommend a shift from the accrual to the expenditure concept of income, our task in the field of corporation taxation would be greatly simplified, we were eager to learn whether such a recommendation was probable. We discovered that there was no support whatsoever in the capital gains committee for a proposal to abandon the accrual concept.

Twenty years ago T. S. Adams remarked that the question of taxing undistributed profits lies at the very heart of the subject of business taxation. He pointed out that if the personal income tax were to be applied only to profits actually distributed, then it would be logical to exempt that portion of salaries and other personal income that are invested, or saved.[34]

If savings in general are to be included in the personal income tax base, there seems to be no escape from the conclusion that individual interests in corpôrate savings or undivided profits must somehow be brought to account. Otherwise the evasion and inequity becomes intolerable. Some of the more promising techniques for accomplishing this task involve a tax directly on the corporation. Consequently it may follow that the use of a federal corporation tax designed to supplement the personal income tax and to make it effective must be accepted as a primary objective.

The difficulty above described, traceable to the interposition of a legal entity such as the corporation between the source of the income and the individual recipients, is one which has confronted the law makers of every country imposing progressive personal income taxes and the specific plans that have been evolved to meet the situation cover a wide range. One of the members of our committee, Dr. Colm, has assembled data bearing upon practices in foreign countries which we publish as an appendix to this report. Such information helpfully supplements our knowledge of the experiences of this country and contributes materially to an intelligent appraisal of the potentialities and limitations of the various plans.

Equity demands that values accruing to individuals ascribable to undistributed profits of corporations be taxed as highly as distributed profits, but technically this is difficult of accomplishment.

[34] "Taxes on Income and Excess Profits," *American Economic Review*, Supplement, 1918, pp. 25-26.

To describe and discuss all the numerous detailed schemes that have been adopted or suggested to meet the difficulty of applying the personal income tax in a world thickly populated with fictitious personalities owned by non-fictitious persons, would be out of place in this preliminary report, especially since the committee is unprepared at this time to pass its final critical judgment upon them. Here we shall restrict ourselves to a few general statements indicating the general types of techniques available.

In the first place the problem seems to be theoretically susceptible of a completely satisfactory and precise solution only if the value of the beneficial interests in the corporation can be accurately appraised at regular intervals. If this were practicable, the corporation itself might be ignored as a subject of taxation so far as the personal income tax is concerned. The obstacles, however, to a solution of this type are obvious. There are legal and administrative difficulties of a serious nature in addition to the limitations of the available techniques of appraisal. Whether there are certain areas within which these difficulties are not insurmountable is one of the questions of interest to the committee.

If it is impracticable to determine individual tax liability for corporation saving by means of valuations, the next most attractive approach from the point of view of theory, is essentially the device long used in this country in the case of partnerships, namely, individual taxation on the basis of distributive shares of the corporate profits, whether distributed or not. Here again there are great difficulties, not so many as are involved in the first type of plan, but nevertheless difficulties so serious in the case of corporations of complicated structure as probably to render the plan unavailable without resorting to arbitrary allocations of earnings. Foreign experience seems to indicate, however, that there are large areas within which such an approach might be successful. This type of plan would presumably involve information returns from corporations but would involve no tax on the corporation itself.

The third approach involves the forcing of actual physical distributions of the corporate earnings to the shareholders. If the value of the individual interests cannot be satisfactorily allocated without actual distribution, the question arises as to whether the end in view justifies a forced distribution. The end in view in this discussion, it should be observed, is merely the proper determination of personal tax liability and not such indirect by-products as an assumed improvement in the distribution of available capital resources, a correction of an alleged tendency for savings to outrun investment opportunities or the presumedly desirable increased governmental supervision and control of the investment process. Such by-products may enter to complicate the appraisal of this third type of approach and obviously have played a part in the controversy over the undistributed profits tax. It should be noted that theo-

retically an undistributed profits tax designed to force distributions should be a tax sufficiently high to accomplish its object and to prevent the frustration of its object. It should be a tax which no corporation would ever pay.

The fourth type of solution of the problem is the first to involve a tax which corporations would pay. However, even this tax would not be, strictly speaking, a tax on the corporation but rather a tax paid by the corporation on behalf of its stockholders. This type may take many different forms. The corporation may be asked to pay, on the average, what it is estimated its stockholders would have had to pay, were the profits fully and promptly distributed and the stockholders permitted to ignore dividends received. Or the corporation may be asked to pay tax at a given rate with more or less precise adjustments by the stockholders when they receive dividends declared out of profits which have been subjected to the corporation tax. If the rate is fixed at a point unduly low or if the adjustments when dividends are distributed are unduly liberal a premium on the withholding of profits is inevitably offered. Any general corporation rate, unless coupled with extremely complicated adjustments will yield only a crude and approximate solution of the problem.

Within the range of these four general types of solution, a specific plan must be evolved. However, there are still other complications. If gross discrimination against or in favor of this particular form of ownership organization is to be avoided, it is important that care be taken to define the corporate income base so as to make it harmonize with the individual income base. The arbitrary limitations on the deduction of certain types of losses, the insulation of the affairs of one accounting period against the unfavorable factors developing in preceding and succeeding accounting periods, the prohibition of consolidated returns, the limitations upon the deduction of dividends received from other corporations and many other similar provisions in the present revenue act serve to render the corporate income base unfit for use as a means of collecting the shareholder's tax from the corporation itself.

Finally another set of complications arises in connection with all four of the types of solution discussed above, namely those associated with an effort to preserve the identity of certain items of corporate income, entitled to special treatment, as these payments pass through the hands of the corporation on their way to the shareholders. If the corporation is regarded as in essence a mere agent of its stockholders, such items as tax-exempt interest should remain tax-exempt when received by the shareholders in the course of dividend distributions. How to trace and identify these items on their travels and how to apportion them among the beneficial owners when the corporate structure is complicated are problems for which precise solutions may be beyond the realm of practical attainment.

b. The Corporation Tax as a Business Tax. As has been seen, a decision that it is necessary to reach the undistributed profits of corporations for personal income tax purposes may involve a tax payable by the corporation on behalf of its shareholders, but this does not preclude the possibility of imposing additional taxes on corporations, which may or may not use net income as a base and whose theoretical justification may rest on grounds of special benefit rather than ability to pay.

The legal right of the corporation to be and to do business forms the foundation for a large array of state organization and franchise taxes. The question may be raised as to whether federal taxes of a similar character have a proper place in the tax structure. Even though the corporate charters are issued by the individual states, it is possible for the federal authority to impose taxes on the issuance and transfer of stock and to levy excise taxes on corporations. Taxes restricted to corporations and not applying to unincorporated business must find their justification in special privileges granted the corporations. Interesting questions arise as to the desirability and the practical consequences of a policy which develops special corporation taxes to the point where they tend to offset more or less completely the advantages accruing from the use of the corporate form.

To the extent that corporations are subjected to taxation as businesses, rather than as the recipients of special benefits through their charter and corporate rights, it would appear reasonable, in the absence of special considerations to the contrary, to subject unincorporated business to similar taxation. The result then is not corporation taxation as such, but a tax on corporations as a feature of a comprehensive business tax. At this juncture a large number of questions arise. Is a tax on business desirable as a federal tax or should this subject be left exclusively to the states? If the federal authority does levy such a tax in the presence of state taxes of the same general character, should an effort be made to accommodate the federal tax to the existing state taxes with respect to such matters as rates, tax bases and the restrictions on the powers of the states in dealing with interstate business? What is the most desirable base for a general federal tax on business, or a federal business tax on corporations—excess profits, net income, operating income, value added by manufacture, gross receipts, sales, or some other base?

At the present time, as has been pointed out above, the federal taxes on corporate income, on capital stock and excess profits can properly be described as business taxes, of limited application, of an impersonal objective character, which can be justifiable theoretically only by reference to benefits received. Taking account of the problem of the possible use of a corporation tax as a part of the personal income tax, what should be the future of these existing federal

levies? In general the committee realizes that it is a part of its task to consider whether it is desirable or necessary that an objective business tax should form a part of the federal revenue system and, if so, what shall be the scope and character of such a tax.

c. The Use of Federal Corporation Taxes to Further Certain Economic Policies. The desirability of making deliberate use of taxation for other than direct fiscal ends has long been a subject of dispute among writers on public finance. At one extreme some of the radicals contend that a redistribution of wealth should be the primary objective in formulating a tax system. At the other extreme the conservatives maintain that the modest aims of raising money with due regard to traditional canons are sufficient, if not more than sufficient, to exhaust the ability and ingenuity of the architects of the revenue structure and that the introduction of other objectives can serve only to obstruct the accomplishment of the real task of taxation.

No one who has occasion to follow the public discussions of tax problems can fail to be impressed by the extent to which the debate is conducted in terms of remote and indirect economic repercussions attributed to the measure. In spite of the extreme difficulty of tracing causal relationships in this field, a given tax measure is often supported or opposed by dogmatic assertions regarding repercussions on business initiative or on the incentive for home ownership, or on the trend toward large-scale business units and monopoly. Peculiarly enough, those who violently disapprove the deliberate formulation of a tax program with a view to promoting desirable economic repercussions are often quick to cite undesirable economic repercussions as arguments against a measure which they dislike.

This much is clear. It is not possible to transfer purchasing power from private pocket-books to the public treasury, in the quantity required by modern budgets, without disturbance to economic values and incentives. An attitude of stolid unconcern toward the disturbance does nothing whatsoever to prevent its occurrence. When a choice is available between alternative revenue measures, the first of which promises to produce economic effects considered desirable by the community, and the second involves undesirable economic repercussions, it is intelligent to choose the first.

With the increased emphasis that has recently been placed upon the role of the government as a directive and controlling force in the economic life of the country, the dispute as to the proper function and purpose of taxation has entered a new phase. The issue is of particular importance in the field of the federal taxation of corporations. The undistributed profits tax of 1936, for example, found support from some who believed that it would serve as a corrective in a national economy unbalanced by over-saving and under-consumption, from some who believed it would prevent the waste of capital believed to be involved when corporations financed ex-

pansion from their own profits and from those who believed that it would make possible the extension of desirable government supervision and control of the entire investment market.

Today numerous proposals are being urged that involve the use of federal taxes on corporations, to accomplish such objects as the full utilization of plant, the discouragement of monopoly and even the encouragement of profit sharing. Some of these proposals imply the existence of a completely planned and controlled economy. Many of the schemes have obviously been formulated by persons with little or no appreciation of the limitations of taxation as a means for achieving the ends they have in view.

Certainly one of the most delicate tasks before your committee is that of passing judgment on questions regarding the use of federal taxes to further such economic ends. Granting that when a given economic program has been incorporated into established public policy, it is desirable that tax policy be brought into harmony with it, a range of difficult questions remain as to the weight to be given to objectives of this general type.

On the issues as to which of the above discussed objectives are acceptable as ends to be sought in levying federal taxation and as to the relative importance to be ascribed in cases where the simultaneous accomplishment of all desirable objectives is not possible, there exists at present little agreement, even among well-informed and public-spirited students of the problem. These issues have been debated at some length at the meetings of our committee but our discussions have not yet proceeded to the point where we can attempt to formulate any theme approaching a precise definition of our position. Even if it should ultimately prove to be impossible to formulate a pronouncement on these fundamental issues which will command the full and unqualified support of all of the committee members, we hope that a clear indication of the position of the individual members will be illuminating and will serve to advance the discussion of the general problem.

V. Criticisms of the Undistributed Profits Tax of 1936

While the committee has given much consideration to the question of the undistributed profits tax, it becomes apparent on careful study that an appraisal of the principle underlying this tax involves a consideration of the fundamental theories underlying the whole system of taxation, and the committee has not yet been able to formulate any statement on the general question which can be submitted at this time. The committee hopes to submit a full statement on the subject before the next meeting of the association.

There is general agreement, however, as to the existence of certain defects in the system of taxation of undistributed profits laid down in the revenue act of 1936, a few of which are listed below.

(1) The statute required that, in order to qualify for purposes of the dividend-paid credit, it was necessary that shareholders should actually receive the dividends during the taxable year for which the credit was claimed. This requirement in effect imposed upon the corporations the unreasonable task of making a forecast of profits before the end of the accounting year and of distributing dividends in anticipation of events that had not yet occurred, with painful penalties involved in case of innocent miscalculations.

(2) The statute contained no mechanism for the painless correction of honest mistakes in the determination of net income at the end of a taxable year. A corporation, which after reporting its net income at a given figure found that it had innocently understated the amount, was unable to avoid the burden of the special rates by subsequent distribution of dividends. Under the American administrative procedure of post-audits, rather than pre-audits of tax returns, this defect was particularly grievous.

(3) The statute failed to permit the happenings of one taxable year to influence the calculation of the tax base for succeeding years. The rigid restriction of the computation to the short period of twelve months, implicit in the denial of the privilege of carrying forward losses to subsequent years, resulted in a substantial discrimination against businesses with fluctuating earnings. The heavy industries particularly suffered as the result of this discrimination. While the carry-forward of losses would not completely remove the hardship suffered by the fluctuating industry, it would substantially mitigate it.

(4) The statute discriminated in favor of concerns which chanced to be subject to certain types of definite contractual obligations restricting their freedom to declare dividends as compared with concerns not subject to such contracts.

The purpose of this preliminary report is achieved when it has sketched the factual background of the problem of the federal taxation of corporations, if it has raised the significant issues, if it has indicated some of the limitations within which an acceptable solution must be sought, and if it has acquainted the members of the association with the general character of your committee's approach to its task. If it is the desire of the association that the life of the committee be extended, we are willing to undertake the formulation of a program for the federal taxation of corporations in the light of the criticism and suggestions of this conference.

Respectfully submitted,

Robert Murray Haig, *Chairman*

APPENDIX NUMBER ONE TO PRELIMINARY REPORT ON THE FEDERAL TAXATION OF CORPORATIONS

INTERNATIONAL COMPARISONS OF CORPORATION TAXES

GERHARD COLM

Explanatory Note. — In response to a request from the committee, Dr. Colm prepared several memoranda dealing with the taxation of corporations in foreign countries and these memoranda have been of great interest to the members of the committee in connection with their consideration of the problem of future policy in this country. In view of the desirability of making the information generally available at the earliest possible date, Dr. Colm was asked to summarize his memoranda for publication as an appendix to this preliminary report of the committee. This Dr. Colm kindly consented to do, in spite of the fact that he considered his memoranda incomplete and tentative in character. In view of the possibility of future revisions, corrections of misstatements of fact and criticisms of the form will be eagerly welcomed. In the preparation of these data, the assistance of Mr. Werner Pese is acknowledged.—ROBERT MURRAY HAIG, *Chairman.*

In the following tables a survey is presented of taxes imposed on corporations in foreign countries.

Table 1 summarizes the data regarding the rates and bases of the corporate income taxes in 54 countries for the years 1934 to 1938.

Table 2 describes the interrelations between corporate and individual income taxes in Canada, Great Britain, the United States, France, Germany, and Italy.

Table 3 attempts to make clear the rôle of corporate income taxes in the general scheme of business taxation in the same six countries.

Table 4 lists examples of incentive and penalty taxes found in the business tax systems of the various countries.

Table 5 explains the practice with respect to intercorporate dividends, consolidated returns and carry-over of losses under the corporate income laws of five important countries.

Comments on Table 1

Almost all countries use the corporate profits tax as a source of taxation with maximum tax rates ranging from 3.5 to 40 per cent.

In 15 countries the basic top rates increased since 1934. In 36 countries they remained constant, in 3 countries they declined.

In 20 countries the rate, at present, varies from 3.5 to 10 per cent; in 22 countries, from over 10 to 20 per cent; in 7 countries, from over 20 to 30 per cent; in 4 countries, from over 30 to 40 per cent.

Thirty-four countries apply a flat basis rate, 20 countries have a progressive basis rate scale.

At present 11 countries apply additional special rate scales to a selective base, usually called "surtaxes". Eight of these are graduated. Most of them intend to tax profits exceeding either certain amounts or certain rates of capital return deemed excessive by the law. Only the surtaxes of Norway and Chile are imposed on undistributed profits.

Comments on Table 2

In no country are corporate and individual taxes brought into accord in such a way that all business profits, whether earned by incorporated or unincorporated concerns and whether distributed and undistributed profits, are taxed equally.

In most countries corporate incomes are taxed by the corporate income tax, and the distributed part of the income is taxed once more by the individual income tax, the result being a double tax on corporate profits. In a few countries there exist profit taxes on unincorporated business, but the rates are much lower than those on corporations. Undistributed profits of corporations are usually subject only to the corporate income tax, which in most countries is much lower than the individual income tax rates in those brackets to which the majority of the stockholders belong.

Germany is the only example of a country which imposes on all corporate profits (both distributed and undistributed) a tax substantially as high as the top rates of the individual income tax. In that country, a heavy double taxation is imposed on distributed profits, but nevertheless undistributed profits of corporations do not have the usual tax advantages compared with the profits of partnerships. In general, it can be said of the German practice that the distributed part of corporate profits is more heavily taxed than the profits of partnerships, and that the undistributed profits of the corporations enjoy a certain tax advantage, unless the owners belong to the lower brackets of income receivers.

In a number of countries an attempt has been made to mitigate the inequality in taxation of the distributed and non-distributed portion of corporate profits. In Great Britain, for example, the individual taxpayer is permitted to deduct dividends received from his income before applying the normal income tax. Since corporations do not pay surtax, no double taxation of the distributed profits exists. For stockholders in the lower income ranges, the British practice results in a slight tax advantage in case profits are distributed, while for stockholders subject to the surtax, the distributed part of their share of the corporate earnings is much more heavily taxed than the undistributed portion. Since the corporations pay the normal tax on their profits and deductions are permitted by individual taxpayers for the distributed portion, this arrangement

implies a 27½% tax on the undistributed profits of corporations. In Belgium (not included in Table 2) the effort to mitigate the inequality takes a different form. There the corporations are permitted to deduct the distributed portion of their profits in arriving at their tax base. The individual taxpayer includes dividends received in his taxable income. Yet also here the corporate tax is lower than the personal income tax in the brackets to which most stockholders belong. Hence the discrimination against distributed profits is mitigated but not eliminated. To the same type belongs the tax credit device incorporated in the revenue act of 1938 in the United States with the difference only that the tax credit is much smaller than in Belgium.

A special tax on non-distributed profits exists in France, Norway and Chile. (Norway and Chile are not included in Table 2.)

Two European countries, viz. Italy and the Netherlands, have a special tax on the *distributed* portion of profits designed to stimulate the "plowing back" of profits. Moreover the *German* corporation tax provides for a levy on the disbursement of dividends, if these disbursements exceed 4% of the capital, and to the extent to which these disbursements exceed the available profits of the current year.

Comments on Table 3

Corporate income taxes constitute only one among several types of taxes imposed on business. No international comparison of corporate income taxes is valid unless such taxes are analyzed as one element in the whole system of business taxation. In most countries businesses pay, besides profit taxes, levies imposed on real estate, property and payrolls, the latter especially for purposes of social security. Again, some countries levy certain taxes on business that are partly survivals of the old methods of "ad rem" taxation and partly new attempts to base business taxation on a number of factors. Besides the taxes already mentioned, various levies are imposed on business capital, on buildings used in business, on sales, on financial transactions, on means of payment, etc. Finally, a number of consumers' excise taxes are, in a fundamental sense, business taxes, such, for instance, as taxes on motor vehicles for the use of business. Since these various factors play a different rôle for various types of businesses, an inequality on the tax burden results. It can be said that in no country an attempt has been made to impose an approximately equal tax burden as among corporations on the various factors of operation.

Because the German taxes imposed on business were apparently higher than those in any other country, an attempt has been made there, earlier than in other countries, to transform a multitude of various taxes into a coherent system of business taxation. The federal German government collects a tax on profits and capital.

Local authorities tax business according to patterns prescribed by federal law. Capital and income are the primary bases of the local tax, but capital defined so as to include both equity and long-term debts, and income defined so as to include profits and interest payments on long-term debt. By using capital as a basis, in addition to profits, businesses are compelled to pay a substantial amount of taxes whether or not they make profits in a specific year. By prescribing the broad definition of capital and profits for the local taxation, the intent is to diminish the tax advantage which otherwise exists for businesses financed by debt rather than equity and to provide a less variable source of local revenue.

In general, it must be said that a survey of business taxation in various countries reveals the chaotic state of affairs.

Comments on Table 4

Here is presented a compilation of cases of discriminatory tax provisions, by which it is intended to pursue aims of economic or social policy. No analysis of the effects of such measures is attempted. The examples refer not only to corporate taxes proper but also to a variety of other taxes on business in general. Many discriminatory provisions, exemptions as well as additional penalty taxes, are found in the sales or turn-over tax laws. The list is selective and is far from complete.

The discrimination in the treatment of the distributed and non-distributed portions of profit (with the intention, in some cases, of fostering distribution of dividends, in other cases, of fostering "plowing back" profits) is neglected here, since it has been dealt with in the second table. Nor is there included tax legislation which, though not enacted with the intention of pursuing aims of economic policy, results in discriminations between various types of businesses.

Comments on Table 5

In this table an attempt is made to show how certain technical problems that necessarily come up in taxing corporations have been dealt with in a few countries. The treatment of intercorporate dividends, consolidated returns and of the carry-over of losses is illustrated by a few examples.

Canada and Great Britain have the most liberal provisions as regards intercorporate dividends. The Canadian and the British income tax laws (as well as the British Defense Contribution) do not impose a double tax burden on any corporation receiving dividends from another corporation, provided the latter has paid income tax on its profits before. Consequently, a special provision granting relief from a double tax burden is superfluous.

The United States tax applies to only 15 per cent of the dividends a corporation receives from another corporation subject to income tax payment.

Germany, which imposes a double tax burden upon corporations, exempts intercorporate dividends in the event that at least one quarter of the controlled corporation is owned by the parent corporation, while France grants tax exemption in the same case only if 50 per cent or more of the shares are in the hands of the parent corporation.

A privilege often granted to an affiliated group of corporations is that of filing consolidated returns. This privilege becomes valuable in cases where losses of one corporation can be offset against the profits of another corporation of the group. While in general affiliated groups in Britain and Germany can elect to file consolidated returns, in the United States this privilege is restricted to carriers and to affiliated groups, the parent corporation of which owns at least 95 per cent of at least one of its subsidiaries and, in Canada, to cases in which the parent corporation owns all the stock of its subsidiaries. The British Defense Contribution requires 95 per cent ownership.

Great Britain can boast also of the most liberal legislation with respect to carry-over of losses from one year to the next. The British law permits the carry-over of losses until the seventh year after the loss, France allows a carrying forward of losses over five years, the United States only over two years. Germany, whose new corporation tax law fails to deal with the problem explicitly, allows losses incurred two years prior to the current fiscal year to be set off against profits of the current year.

TABLE 1

International Survey of Corporate Income Taxes (1934–1938)

Legend:	*Abbreviation*	*Legend:*	*Abbreviation*
Taxable income	TI	Net profits	NP
Profits (net income)	P(NI)	Undistributed profits	UP
Net income	NI	Distributed profits	DP
Profits	P	Assessed income	AI

Sources: Tax Systems of the World, 4th, 5th, 6th and 7th ed. Comparative Law Series. Commerce Reports. Financial and economic annuals of different countries.

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Australia (Commonwealth)	Income tax	Rate of tax	5%	5%	5%	5%	5.75
		Surtax	—	—	—	—	—
		Basis	NP			TI	
British India	Income tax	Rate of tax	16.9% [a]	16.9% [a]	14.7% [c]	14.7% [c]	14.7% [c]
		Surtax	7.8% [b]	7.8% [b]	6.8% [d]	6.8% [d]	6.8% [a]
		Basis	NP			TI	TI
Canada	Income War tax Act	Rate of tax	12.5%	13.5%	15%	15%	15%
		Surtax	—	—	—	—	—
		Basis	P(NI)	P(NI)	P(NI)	P(NI)	P(NI)

[a] 13.54% plus 25% surcharge.

[b] 6.25% plus 25% surcharge on income above 20,000 rupees.

[c] 13.54% plus a surcharge in an amount equal to 1/12 of the normal income tax.

[d] 6.25% plus a surcharge in an amount equal to 1/12 of the supertax on incomes above 50,000 rupees.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Great Britain	Income tax	Rate of tax Surtax Basis	25% — NI	22.5% — NI	23⅓% — NI	25% — NI	27.5% — NI
	National Defense contribution	Rate of tax Surtax Basis	— — —	— — —	— — —	5% — P	5% — P
New Zealand	Land and Income tax	Rate of tax Surtax Basis	3.3–29.25% [e] e NP	3.3–29.25% [e] e NP	5–37½% — NP	5–37½% — NP	
Union of South Africa	Income tax	Rate of tax [f] Surtax Basis	10% — NP	8.75% — NP	8.75% — NP	8.75% — NP	10% — NP
Irish Free State	Income tax *	Rate of tax Surtax Basis		22½% —	22½% —	22½% — NI	
United States	Income tax	Rate of tax Surtax Basis	13.75% — NI	13.75% — NI	13.75% — NI	13.75% — NI	
Austria	*Körper-schafts-steuer*	Rate of tax Surtax Basis	28.5% [g] g NP [h]	28.5% [g] g NP [h]	28.5% [g] g NP [h]	25% — NP [h]	

* Corporate profits are also subject to a 7½% operation profits tax deductible from income tax payments.

[e] 3–22.5% plus 30% of basic rate. [f] 2 shillings and sixpence for each £. This tax was subject to a 20% rebate in tax years 1934 and 1938, and to a 30% rebate in tax years 1931–37.

[g] Tax rate: 20% plus 11.4% of basic rate. [h] Net profits of previous year.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Belgium	*Tax Professionelle*	Rate of tax	Graduated up to 10.89% [i]	Graduated up to 10.89% [i]	Graduated up to 10.89% [i]	Graduated up to 10.89% [i]	
		Surtax	i	i	i	i	
		Basis	UP	UP	UP	UP	
Czechoslovakia	Profits tax	Rate of tax	9%	9%	9%	9%	
		Surtax	Graduated 2–6%	Graduated 2–6%	Graduated 2–6%	Graduated 2–6%	
		Basis	NP	NP	NP	NP	
Danzig	*Körperschaftssteuer*	Rate of tax	20% Industrial—10% others	20% Industrial—10% others	20% Industrial—10% others	20% Industrial—10% others	
		Surtax	Graduated ¾–6% [j]	Graduated ¾–6% [j]	Graduated ¾–6% [j]	Graduated ¾–6% [j]	
		Basis	NI	NI	NI	NI	
Denmark	Income and property tax	Rate of tax	Graduated 6–20%	Graduated 6–20%		Graduated 8.75–25% [k]	
		Surtax	—	—		k	
		Basis	NI	NI	NI	NI	
Estonia	Income tax	Rate of tax	Graduated 4.5–32.4%	Graduated 4.5–32.4%	Graduated 4.5–32.4%	Graduated 4.5–32.4%	
		Surtax	—	—	—	—	
		Basis	NI	NI	NI	NI	

[i] Tax rate: graduated up to 9.9% plus 10% of basic rate. [j] Emergency tax levied on income since Oct. 10, 1934.
[k] Tax rate: graduated from 7 to 20% plus 25% of basic rate till March 1938.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Finland	Income tax	Rate of tax Surtax Basis	Graduated 0.4–20% — NI	Graduated 0.4–20% — NI	Graduated 0.4–20% — NI	Graduated 0.4–20% — NI	
France [2]	Commercial and Industrial Profits tax	Rate of tax Surtax Basis	Graduated up to 15% — NP	12% — NP	12% — NP	12% — NP	
	Undistributed Profits tax	Rate of tax Surtax Basis	— — —	— — —	— — —	4% — UP	
Germany	*Körper-schafts-steuer*	Rate of tax Surtax Basis	20% — NI	20% — NI	20% — NI	30% — NI	35% [1] — NI
Hungary	Corporation tax	Rate of tax Surtax Basis	Graduated 16–30% — NI	Graduated 16–30% — NI	Graduated 16–30% — NI	Graduated 16–30% — NI	
Italy	Tax on Income from movable property	Rate of tax Surtax Basis	14% — NP	14% — NP	14% — NP	14% — NP	

[1] 40% for 1939. [2] These statements describe the situation as it existed in France before the Daladier's decrees of May 2, 1938, which increased the rates by eight per cent and before the new decrees of November 13 and 14, 1938.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Latvia	Trade and Industry tax	Rate of tax ...	Graduated 7.5–30% [m]	Graduated 7.5–30% [m]	Graduated 7.5–30% [m]	Graduated 7.5–30% [m]	
		Surtax	m	m	m	m	
		Basis	NP	NP	NP	NP	
Lithuania	Commercial, Industrial and Trade profit tax	Rate of tax ...	15%	15%	15%	15%	
		Surtax	—	—	—	—	
		Basis	Excess of gross profits over 3%	Excess of gross profits over 3%	Excess of gross profits over 3%	Excess of gross profits over 3%	
Luxemburg	Income tax	Rate of tax ...	1.6–14.4% [n]	1.6–14.4% [n]	1.6–14.4% [n]	1.6–14.4% [n]	
		Surtax	n	n	n	n	
		Basis	NI	NI	NI	NI	
Netherlands	Companies' profit tax	Rate of tax ...	9.05%	9.05%	9.5%	10.05%	
		Surtax	—	—	—	—	
		Basis	DP	DP	DP	DP	
Norway	Income tax	Rate of tax ...	6%	6%	10%	10%	11.4%
		Surtax	8% of undistributed profits	8% of undistributed profits	8% of undistributed profits	8% of undistributed profits	6.5% of undistributed profits
		Basis	NI	NI	NI	NI	NI
Poland	Income tax	Rate of tax ...	Up to 25%	Up to 25%	Up to 35%	Up to 35%	
		Surtax	—	—	—	—	
		Basis	NI	NI	NI	NI	
Portugal	Commercial and Industrial profits tax	Rate of tax ...	3.5%	3.5%	3.5%	3.5%	
		Surtax	—	—	—	—	
		Basis	Share prices	Share prices	Share prices	Share prices	

[m] Tax rate: graduated 5–20% plus 50% of basic rate.

[n] Tax rate: graduated 1–9% plus 60% of basic rate.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Rumania	Income tax	Rate of tax	10%	10%	10%	10%	
		Surtax	Graduated tax on net profit above 10%	Graduated tax on net profit above 10%	Graduated tax on net profit above 10%	Graduated tax on net profit above 10%	
		Basis	NP	NP	NP	NP	
Spain	Income tax	Rate of tax	5.5–17.25%	5.5–17.25%	5.5–17.25%	5.5–17.25%	
		Surtax	—	—	—	—	
		Basis	Profits on capital investment	Profits on capital investment	Profits on capital investment	Profits on capital investment	
Sweden	Income tax	Rate of tax		Graduated 2.55–20.4% [o]	Graduated 2.55–20.4% [o]	Graduated 2.55–20.4% [o]	
		Surtax		o	o	o	
		Basis	Profits and Property	Profits and Property	Profits and Property	Profits and Property	
Yougoslavia	Income tax	Rate of tax	12%	12%	12%	12%	
		Surtax	2–15% [p]	2–15% [p]	2–15% [p]	2–15% [p]	
		Basis	NP	NP	NP	NP	
Japan	Income tax	Rate of tax	5%	5%	5%	10%	12.25%
		Surtax	4–20% [q]	4–20% [q]	4–20% [q]	4–20% [q]	4–20% [q]
		Basis	NP	NP	NP	NP	NP
	North China Affair Special tax	Surtax	— — —	— — —	— — —	10% of normal Income tax	

[o] Basic scale: 1.5–12%. Parliament fixes yearly the percentage for the tax: 1935–37: 170%.

[p] According to percentage of profits to invested capital.

[q] Where profits exceed 10% of the average paid-up capital and reserves, the excess is subject to the progressing excess profit tax from 4–20%.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Japan (*continued*)	China Incident Special tax					15% of Special Profits	
	Business Profits tax	Rate of tax Surtax Basis	3.4% — NP	3.4% — NP	3.4% — NP	4% — NP	
	Special Profits tax	Rate of tax Surtax Basis	— — —	10% of Excess Profits — r	10% of Excess Profits — r	15% of Excess Profits — r	
Barbados	Income tax	Rate of tax Surtax Basis		10% — NI	10% — NI	10% — NI	12.5% — NI
British Guiana	Income tax	Rate of tax Surtax Basis		12½% — NI	12½% — NI	12½% — NI	
British Honduras	Income tax	Rate of tax Surtax Basis		8% — NI	8% — NI	8% — NI	

r Profits exceeding the average of the preceding three years.

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Ceylon	Income tax	Rate of tax Surtax Basis		10% — NI	10% — NI	10% — NI	
Iran	Taxes on firms	Rate of tax Surtax Basis		3–4% — NP	3–4% — NP	3–4% — NP	
Iraq	Income tax	Rate of tax Surtax Basis		9% — NP	9% — NP	9% — NP	
Jamaica	Income tax	Rate of tax Surtax Basis		1–10% NI		Up to 10.4% NI	1.04–20%
Netherlands India	Company tax	Rate of tax Surtax Basis		10% + 100% surcharge — NP	10% + 100% surcharge — NP	10% + 100% surcharge — NP	
Philippine Islands	Income tax	Rate of tax Surtax Basis		3% — NP	6% — NP	6% — NP	
Siam	Income tax	Rate of tax Surtax Basis		8% — Dividends, etc.	8% — Dividends, etc.	8% — Dividends, etc.	

TABLE 1—*Continued*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Trinidad	Income tax	Rate of tax Surtax Basis		12½% — NI	12½% — NI	12½% — NI	
Argentina	Emergency tax on income	Rate of tax Surtax Basis	5% .36–7% NP [s]	5% .36–7% NP [s]	5% .36–7% NP [s]	5% .36–7% NP [s]	
Brazil	Income tax law	Rate of tax Surtax Basis	6% — NI	6% — NI	6% — NI	6% — NI	
Chile	Income tax law	Rate of tax Surtax Basis	6–10% [t] 6% [u] NI	6–10% [t] 6% [u] NI	6–10% [t] 6% [u] NI	6–10% [t] 6% [u] NI	
Colombia	Income tax law	Rate of tax Surtax Basis	1–8% — NI [w]	1–16% 10–30% [v] NI [w]	1–16% 10–30% [v] NI [w]	1–16% 10–30% [v] NI [w]	
Costa Rica	Charity law Cedular tax on income	Rate of tax Surtax Basis	x — NI and P	x — NI and P	x — NI and P	x — NI and P	

[s] Earned in Argentina.

[t] If shareholders pay the tax on dividends, these rates are reduced by one-half.

[u] 6% when income not distributed to natural persons.

[v] Of excess profits, 10% of excess profits over 12–15%, 30% of excess profits over 50%.

[w] Earned in Colombia.

[x] ½% annually: Charity tax: graduated up to 30,000 colones on income of 500,001 and over.

TABLE 1—*Concluded*

Country	Name or Description of Tax	Rates and Basis	1934	1935	1936	1937	1938
Guatemala	Taxes in favor of charitable institutions	Rate of tax Surtax Basis	5% — NI	5% — NI	5% — NI	5% — NI	
Haiti	Income tax	Rate of tax Surtax Basis	5–6% — NI	5–6% — NI	5–6% — NI	5–6% — NI	
Mexico	Income tax	Rate of tax Surtax Basis	2–12.3% — NI	2–12.3% — NI	2–12.3% — NI	2–12.3% — NI	
Paraguay	Progressive income tax on mercantile companies	Rate of tax Surtax Basis	3–5% — DP	3–5% — DP	3–5% — DP	3–5% — DP	
Peru	Progressive income tax	Rate of tax Surtax Basis	5% 1–7% z	5% 1–7% z	5% 1–7% z	5% 1–7% z	
Salvador	Income tax law	Rate of tax Surtax Basis	2–6% — NI	2–6% — NI	2–6% — NI	2–6% — NI	
Puerto Rico	Income tax act of 1924	Rate of tax Surtax Basis	12½% — NI	12½% — NI	12½% — NI	12½% — NI	

[y] Up to 50 balbaos on receipts over 1500 balbaos.

[z] Income in excess of 10% net annually capital invested.

TABLE 2

Discrimination between Distributed and Non-Distributed Portion of Profits and Discrimination between Taxation of Corporations and Partnerships

Income Taxation of Profits from Corporations and Partnerships

Country		Taxation at Source: Undistributed Profit	Taxation at Source: Distributed Profit	Taxation of individual owner with reference to his interest in the corporation or in the partnership: Distributed profit	Taxation of individual owner with reference to his interest in the corporation or in the partnership: Undistributed profit
Canada	Corporation	I. Dominion income tax [n] (15%)		I. Dominion income tax (3–56%) and surtax (additional 5% on income above $5000)	—
		II. Provincial Corporations Tax (Ontario: 1%) [o]		II. Provincial income tax (Ontario: 1.5–28%) [p]	—
	Partnership	—	—	I. Dominion Income Tax	
				II. Provincial Income Tax (Ontario)	
Great Britain	Limited Liability Co.	I. Income tax [h] (1938/39: 27.5%)	—	Income Tax (1938/39: 27.5%) and surtax [h] (5.5–41.25%)	—
		II. National Defense Contribution [h] (5%)			
	Partnership	National Defense Contribution [h] (4%)		Income tax (collected at source) and surtax	

TABLE 2—*Continued*

COUNTRY		TAXATION AT SOURCE		Taxation of individual owner with reference to his interest in the corporation or in the partnership	
		Undistributed Profit	Distributed Profit	Distributed profit	Undistributed profit
UNITED STATES	Corporation	I. Federal corporation tax [q] (12.5–32%)		I. Federal Normal Tax (4%) and surtax (4–75%)	—
		II. State Franchise Tax on business corporation [r] (New York 6%)		II. State income tax (New York: 2–7% plus emergency of 1%)	—
	Partnership	State tax on unincorporated business (New York) (4%) [s]		I. Federal Normal tax and surtax	
				II. State income tax	
FRANCE	Corporation	I. *Impôt sur les bénéfices industriels et commerciaus* [d] (12%)		I. *Impôt sur le revenu des valeurs mobiliers* (withheld at source) [f] (18%)	—
		II. *Impôt sur les reserves des sociétés* [e] (4%) —	—	II. *Impôt général sur le revenu* [g] (1–40%)	
	Société en nom collectif	—	—	I. *Impôt sur les bénéfices industriels et commerciaux* [d] (12%)	
				II. *Impôt général sur le revenu* [g] (1–40%)	

TABLE 2—*Concluded*

Country		Taxation at Source: Undistributed Profit	Taxation at Source: Distributed Profit	Taxation of individual owner with reference to his interest in the corporation or in the partnership: Distributed profit	Taxation of individual owner with reference to his interest in the corporation or in the partnership: Undistributed profit
Germany	Corporation	I. *Körperschaftssteuer* [a] (35% for 1938, 40% for 1939)		Income tax (progressive scale up to 50%) [c]	—
		II. Local business tax [b] (*Gewerbesteuer*) (5%)			
	Partnership	Local business tax [b] (0% on trading profits up to 1200 marks 1% on trading profits from 1200 to 2400 marks 2% on trading profits from 2400 to 3600 marks 3% on trading profits from 3600 to 4800 marks 4% on trading profits from 4800 to 6000 marks 5% on trading profits from 6000 and above)		Income tax [c] (progressive scale up to 50%)	—
Italy	*Società anonima*	I. Tax on income from movable property [i] (*Imposta sui redditi di ricchezza mobile* (Cat. B) (14%)		I. Complementary tax on income (*Imposta complementare sul reddito*) [m] (1–10%)	—
		—	II. Tax on distributed profits (5% on distributed profit constituting 8–9% of paid-in capital and reserves, 10% on those betw. 9–10%, 25% on those betw. 10–12%, 35% on those betw. 12–14%, 60% on those of 14 and over) [k]	II. Tax on profits derived from bearer bonds [l] (10%)	—
	Società in nome collettivo	—	—	I. *Imposta sui redditi di ricchezza mobile* (Cat. B)	
				II. *Imposta complementare*	

Footnotes to Table 2

[a] Law of July 25, 1938. New rates apply only to income above 100,000 marks, for other corporations the old rate of 30% still holds.

[b] The business or trade tax (*Gewerbesteuer*) is imposed on all trading and industrial enterprises by the local authorities on the basis of profits and capital according to a procedure prescribed by Reich law. Each community then fixes yearly the percentage of the tax (e. g. 125% of the basic tax amount). (Real tax reform law of December 1, 1936, effective since April 1, 1937.)

[c] For (Aryan) income receivers having family the normal tax rate varies between 30 and 40%.

[d] Law of December 27th, 1934.

[e] Fiscal Reform Law of December 31, 1936, art. 22.

[f] l.c., art. 51 (bearer securities).

[g] l.c., art. 34-41. Credit of 2½% of distributed profits of corporations above $25,000.

[h] Finance Act of July 30, 1937.

[i] Law of October 16, 1924.

[k] Extraordinary Tax on company dividends. Decrees number 1744 of October 5, 1936 and number 1729 of October 19, 1937.

[l] Decree number 1627, September 1933.

[m] R. D. L. December 30, 1923 (number 3062).

[n] Income war tax of September 20, 1917.

[o] Corporation tax act—R.S.O. 1927 Ch. 29, last amendment 1937, Ch. 2.

[p] Ontario income tax 1936, Ch. 1, amended 1937, Ch. 1.

[q] Revenue Act of 1938.

[r] Tax leg., Art. 9-A.

[s] New York State, Art. 16-A, Tax Law.

Basis for Table 2

Germany. Statistisches Reichsamt. Einzelschriften zur Statistik des Deutschen Reiches. Bd. 23. Internationaler Steuerbelastungsvergleich, Berlin, 1933.

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TABLE 3

Various Forms of Business Taxation in Six Important Countries

CANADA, BUSINESS TAXATION

	PROFITS	CAPITAL	COST FACTORS				SALES	CORPORATE TRANSACTIONS
			Property	*Payrolls*	*Comm'l Instruments*	Others		
Dominion taxes	Income tax (15%)	—	—	—	Stamp taxes on cheques, money orders, travellers' cheques, and bank receipts (3c. on amounts below $100, 6c. on amounts above $100) on postal notes ((1-3c), on bills of exchange and promissory notes (3-6c.)	Cable, radio, telegraph and long distant messages on telephone (b) Tax on automobiles (c) Stamp tax on every letter and postcard (1c.)	Sales tax (8% and annual license of $2.00) (a)	Stock transfer tax (0.1–4.1% per share)
Provincial *and local* taxes (Ontario)	Provincial Corporations tax (1%) Assessment Act: Local levies on income of corporations	Provincial Corporations tax (0.1% on paid-up capital plus $50 on each place of business	Real property and business tax (local assessments of land and improvements and space occupied by business) (rates vary)	—	—	Municipal licenses (privilege of doing business) Land transfer tax (prov. tax on registration of deeds, transfer of land) (0.2% of purchasing price) Registration of motor vehicles (provincial tax) (autos $7–40—trucks $10–375) Gasoline sales tax (prov.) (6c. per gallon)		Corporation organization tax (privilege of forming a corporation of increasing existing capital stock) (Province) (varying rates) Licenses of corporation to hold land (provincial tax) (various rates, minimum fee $50)

(a) Exempt are exporting, agriculture, sales of essential foods, fuels, raw materials, equipment used in the extractive industries, etc.

(b) 5c. per cable, radio and telegraph message, 5c. per phone calls costing more than 25c. 5c. in addition for every 80 c. paid in excess of 80c.

(c) 5% on automobiles valued at more than $650 on the amount in excess of $650. Tax collected shall not exceed $250 per auto.

TABLE 3—*Continued*

GREAT BRITAIN, BUSINESS TAXATION

	PROFITS	CAPITAL	COST FACTORS				SALES	TRANSACTIONS CORPORATE
			Property	Payrolls	Comm'l Instruments	Others		
National taxation	Income tax (25%) National			Social Insurance (b)		Stamp duties on documents (varying rates)	—	
	National Defense Contribution (5%)		Land tax (ownership of land) (Proportion of parochial quota by assessment)	Unem-ployment insurance (a)		Duty on petrol and heavy oil for motor vehicles (9d. per gallon)		
Local taxation			General rate (lands and buildings within the area of the rating authority)					

(a) Weekly contributions of employers of non-agricultural workers: 9d for males and 8d for females in the age groups 21–65; 8d for males and 7d for females in the age group 18–21; 5d for males and 4½ for females in the age group 16–18; 2d for males and females in the age groups under 18.

(b) Compulsory contributory insurance covering medical care, illness, invalidity as well as widows', orphans', and old-age pension: 9d for men, 7d for women per employee per week.

TABLE 3—*Continued*

UNITED STATES, BUSINESS TAXATION

	PROFITS	CAPITAL	COST FACTORS				SALES	CORPORATE TRANSACTIONS
			Property (a)	Payrolls	Commercial Instruments	Others		
Federal Taxation	Corporation tax (12.5–32%)			Social Security taxes (1) Excise tax on employers (2) Tax on employers of 8 or more (3) Excise tax on carriers				Stamp taxes: issue and transfer of securities
State and local taxation (New York State and City)	Franchise tax on apportioned entire net income *	Franchise tax on apportioned issued capital stock *	General property tax (local)	Unemployment insurance (3% of payrolls) (May be credited against federal tax)		Motor Fuel tax Mortgage tax Registration of Motor Vehicles	Sales tax (New York City)	Corporation organizations
	* Alternative taxes		Occupancy tax (local)					License, foreign corporations
	(Unincorporated business, License, 4%)							Stock transfer (3 and 4c. per share)

(a) Owned and used.

TABLE 3—*Continued*

FRANCE, BUSINESS TAXATION

	PROFITS	CAPITAL	COST FACTORS				SALES	CORPORATE TRANSACTIONS
			Property (b)	Payrolls	Commercial Instruments	Others		
National taxation	Tax on industrial and commercial profits (12%)		Impôt foncier (income from real property) (12%) (d)	Social insurance (4% of payrolls)	Transfer tax on bills and notes	Tax on automobiles	Single producers' tax at 6% rate on the sale of commodities at the last stage of production (a)	Tax on formation of a company (3% of capital)
	Undistributed profits tax (4%)		Mortmain tax on corporate owned real estate (18%)	Apprenticeship tax (0.2% of wages and salaries)				
						Transfer tax on title (leases, business, etc.)		
						Transfer of real property or real property rights (13.5% of price)		
						Tax on contracts		
						Tax on capital insured against fire		
Department and local taxation (c)			Additional impôt foncier—levied by departments and communes			License tax for conducting business (fixed tax plus proportion. Tax fixed according to rental value of dwelling and business quarters)		

(a) A number of producers' taxes are levied at particular rate. (b) Owned and used. (c) Incomplete.

(d) Tax is based on rental value ascertained by actual rent paid, by comparison with other property or by direct evaluation. From this rental value 50% depreciation allowance for factories can be deducted.

TABLE 3—*Continued*

GERMANY, BUSINESS TAXATION

	PROFITS	CAPITAL	COST FACTORS: Property (c)	COST FACTORS: Payrolls	COST FACTORS: Commercial Instruments	COST FACTORS: Others	SALES	TRANSACTIONS CORPORATE
REICH	Corporation tax (35% for 1938, 40% for 1939	Industrial charge on working assets above 500.000 marks " Aufbringungsumlage ") (0.4%)	General property tax (" Vermögenssteuer ") (0.5% (b)	Social insurance: Sickness 1/3; Invalidity ½; White collar W. ½; Unemployment ½; Accident 1/1	Bills of Exchange (" Wechselsteuer ") (For each 100 marks or part thereof 10 pfennigs)	Land acquisition tax (" Grunderwerbssteuer ") (3%)	Turnover tax (2%; for deliveries and drawings of agricultural products by the farmer and of essential foods. In all other cases 1.5%–2.5% on retailers with annual sales above 1,000,000 marks) (d)	Taxes on circulating capital (" Kapitalverkehrssteuer " (1) Tax on corporations (2) Tax on securities (3) Tax on turnover of Stock Exchange
						Insurance tax (10% of premium on burglary and glass ins.; 5% of premium on fire ins.; 3% of premium on transport, building risk, and mutual ins.)		
						Automobile 8 marks for every 100 ccm. of stroke volume (a)		
						Tax on documents		
Länder (Prussia)						Stamp tax on documents		
Local	Business and trade tax (" Gewerbesteuer ") (c) (5%)	(0.2%)	Real estate tax (" Grundsteuer ")			Local Land Acquisition tax in addition to National tax (2%, in case of land speculation 2% more)		

(a) Free of tax; automobiles with the date of first admission after March 31, 1933. (b) 0.9% on property exceeding the value of 500,000 marks.

(c) For unincorporated business the rates are degressing. The " Gewerbesteuer " is *levied by the local authorities which base their rate of levy on* the general tax measure rate fixed by the Reich (see above, page ——). Payrolls are used as complementary basis for the tax.

(d) Levy collected to subsidize exports. (e) Owned and used.

TABLE 3—*Continued*

ITALY, BUSINESS TAXATION (1)

	PROFITS	CAPITAL	COST FACTORS				SALES	CORPORATE TRANSACTIONS
			Property (i)	Payrolls	Commercial Instruments	Others		
National taxation	Tax on income from movable property (" Imposta sui reddit; di ricchezza mobile," Cat. B) (14%)	Tax upon the capital and reserves of stock companies (10%, Decree of Oct. 19, 1937)	Extraordinary tax on the value of real estate (0.35%) (d)	Syndical contributions for commercial enterprises having employees (0.40 Lire per 100 Lire paid in salaries) (h)	Substitutes for registration and stamp taxes (commercial paper)	Tax on motor vehicles (b)	Sales tax (3% since Oct. 1937)	Substitutes for registration and stamp taxes
	Tax on distributed profits (a)	Tax on the capital of foreign companies (4.5%)	Tax on land	Unemployment insurance (0.70–2.10 £ per week)		Tax on insurance (c)		Sales tax for stocks and bonds (4.5% for stocks)
	Syndical contributions (1938) £ 20 on revenues up to £ 2000 revenues, £ 51 on rev. 2001–4000, £ 60 on rev. 4001–5000, 1.5% on rev. 5001–25,000, 2% on rev. 25,000–100,000, £ 2500 on rev. above 1,000,000		Tax on building (income or estimated rental value) (10% in addition to taxes imposed by communes and provinces)	Invalidity, old age, maternity, tuberculosis insurance		Stamp tax on documents (d)		Tax on Stock Exchange contracts
						Tax on issuance, renewal, cancellation and increases of mortgages (e)		
						Stamp on documents of transport		

TABLE 3—*Concluded*

ITALY, BUSINESS TAXATION (2)

	PROFITS	CAPITAL	COST FACTORS				SALES	CORPORATE TRANSACTIONS
			Property (i)	Payrolls	Commercial Instruments	Others		
Local taxes (communes and provinces)	Tax on industrial income (3%) (g)		House tax (rental value) (5–9% (f)			Tax on public notices, advertisements etc. (£0.20–7 per letter) (Duties *on public* height and measure)		
			Surtax on real estate (g)					
			Tax on unearned increment on real estate (maximum 15% of appreciation)					

(a) 5% on distributed profits constituting 8–9% of paid-in capital and reserves, 10% on those between 9–10%, 25% on those between 10–12%, 35% on those between 12–14%, 60% on those above 14%.

(b) Rates vary according to type of vehicle. Additional tax for road improvement. Abolished by decree approved by Cabinet Nov. 7, 1938.

(c) Maritime insurance 2%, transport insurance varying, other insurance types 1% of amount of insurance.

(d) Royal Decree of Oct. 5, 1936. Temporary tax for the period of 25 years. Refers to both urban and rural land.

(d) Imposed on all civil and commercial documents, judicial and extrajudicial and other documents prescribed by law.

(e) Original issue 2.5%, renewals 1.35%, transcriptions etc. 1%, increases etc. 0.3%.

(f) According to the category of the communes, and a progressive rate according to rental schedules.

(g) Income subject to the tax on *circulating capital*; *industries and businesses not* subject to the *latter* tax pay £15–60 (tax on licenses).

(g) For each £ of tax on real estate: Land: £2–5 to communes, and £0.50–1 to province; Buildings: £0.50–1.25 to communes, and £0.50–0.75 to provinces.

(h) Up to 5,000 Lire. In addition to syndical contributions to be paid on revenues.

(i) Owned and used.

TABLE 4

Examples of Incentive and Punitive Taxes of Various Types in Different Countries

Industries or developments to be encouraged or protected by the tax provision	Country	Tax	Exemption (E) or Penalty Tax (P)	Special Provisions
1. Specific branches of industry				
a. Agriculture	Canada	Sales tax	E	
	New Zealand	“ “	“	
	France	“ “	“	
	Philippines	“ “	“	
	Brazil	“ “	“	
	Cuba	Highway passenger and freight toll tax		Tax reduced to for motorized vehicles belonging to agric. interests transporting important agric. products and equipment supply used in agriculture (Feb. 1938)
b. Food or agricultural products	Australia	Sales tax	E	
	Hungary	“ “	“	
	Italy	“ “	“	
	Argentina	“ “	“	
	Puerto Rico	“ “	“	
c. Railroads	Great Britain	National Defense Contribution	E	
	Denmark	Real Est. tax	“	
	Estonia	“ “ “	“	
	Poland	“ “ “	“	
	Japan	“ “ “	“	
	Poland	Sales tax	“	
d. Public utilities	Great Britain	National Defense Contribution	E	
	Poland	Sales tax	“	
	Argentina	“ “	“	
e. Publishing	Argentina	Sales tax	E	Newspapers, periodicals, magazines, textbooks
f. Building industry	Germany	Individual income tax; corporate income tax (1933/34)		A portion of expenditures for modernization and repair of buildings deductible from taxable income
		Individual income tax; Property tax. (1933)	E	Income from newly built small residential and private homes tax exempt

TABLE 4—*Continued*

Industries or developments to be encouraged or protected by the tax provision	Country	Tax	Exemption (E) or Penalty Tax (P)	Special Provisions
1. Specific branches of industry (continued)				
f. Building industry	France	Real property tax	E	New construction, remodeling and additions to constructions exempted for 2 years (increased to 15 years)
	Italy	Tax on buildings	E	New residential construction between 1919 and 1935 exempt for 25 years
		General income tax	E	Companies constructing tenement houses exempt
	Martinique	Property tax	E	New buildings exempted for 1 year
	Canada	Municipal taxes	E	National Housing Act 1938. Municipalities in which low rental housing projects are constructed must not levy taxes on such projects exceeding 1%
		Sales tax	E	Building materials exempted (July 1938)
	Czechoslovakia	Direct taxes		Extraordinary depreciation allowance deductible from direct tax basis raised to 20% on houses for industrial workers begun in 1936/1937 (Decree Feb. 1937)
g. Special industries	Germany	Local real estate taxes (1936)		Minister of Finances can lower the rates
2. New enterprises a. General	Germany	Income, business, property and sales tax	E	Refers to new enterprises introducing new productive methods important for the economy as a whole (1933)
b. Power plants	Austria	*Gewerbesteuer* Corporation tax	E E	Same provision (1936). New hydroelectric plants exempt for 10 to 20 years (1937)

TABLE 4—*Continued*

Industries or developments to be encouraged or protected by the tax provision	Country	Tax	Exemption (E) or Penalty Tax (P)	Special Provisions
2. New enterprises (continued) c. Mining	Canada	Corporate income tax	E	New mining enterprises exempted for 3 years
d. Automobile industry	Germany	Tax on motor vehicles	E	
3. Industrialization	Argentina	Sales tax	E	Sales of coal
4. Special areas	Great Britain	National Defense Contribution	E	Treasury can remit part or whole of tax paid by new enterprises in special areas
	Italy	General income tax	E	5 to 10 years exemption for new factories etc. in special areas
5. Colonial enterprises	Italy	Extraordinary tax on corporate profits	E	
		Tax on agr. income		Lower rate for colonial landlords
6. Native Cooperatives	Netherlands India	Corporate income tax	E	Exemption extended for 10 years (decree of April 1938)
7. Cooperatives	France Poland	Sales tax for large retailers Sales tax	E	
8. Government enterprises	France Germany Italy Poland Germany	Sales tax " " " " " " Corporate income tax and *Gewerbesteuer*	E " " " E	
9. Rationalization of industry	Great Britain	Income tax (Fin. Act 1935, sec. 25)		Reduction from profits of contributions paid to rationalize industry allowed

TABLE 4—*Concluded*

Industries or developments to be encouraged or protected by the tax provision	Country	Tax	Exemption (E) or Penalty Tax (P)	Special Provisions
10. Purchase of industrial equipment	Germany	Individual and corporate income tax		Expenditures for new equipment deductible from taxable income (repealed for 1937)
	Czechoslovakia	Direct taxes		20% depreciation allowances for capital investments undertaken in 1936 or 1937
11. Credit facilities	Italy	Capital levy	E	Banks and credit institutions exempt
12. Foreign investments	Italy	Inheritance tax	E	
	Panama	Income tax	E	Foreign companies exempted from payment of income tax on business derived outside of country
13. Independent traders	Czechoslovakia	Special sales tax	P	½% imposed on sales of domestic cartels
14. Interstate commerce	Brazil	Interstate export taxes		To be extinguished by 1943
15. Encouraging home ownership	Peru	Fiscal and local real estate taxes	E	Houses used exclusively by owner exempted for 5 years in main cities (Sept. (1938)
16. Small retailers (a)	France	Special tax on turnover	P	Progressive rates for large retailers
	Germany	" " "	P	
	States in U. S. A.	Chain store taxes	P	
	Cities in Canada	" " "	P	
Curbing speculation	Sweden	Compensation tax law	P	Imposes levy on undistributed profits of real estate and marketable securities companies (1938)

(a) Another method of assisting small business is a tax-exempt limit or a regressive rate.

TABLE 5

Treatment of Intercorporate Dividends, Consolidated Returns and Carry-over of Losses in Six Important Countries

1. *Intercorporate dividends and privilege to file consolidated returns.*

Canada

a) Intercorporate dividends.

Dividends received by one Canadian company from another Canadian company are ordinarily exempt from income tax, provided the latter company has paid a tax upon its profits. (par. (n) of Sec. 4.)

b) Privilege to file consolidated returns.

Corporations owning or controlling 100% of stock of one or more companies have the option of filing consolidated returns. Tax rate increases in this case from 15 to 17%.

> "A company which owns or controls all of the capital stock, less directors' qualifying shares, of subsidiary companies which carry on the same general class of business and have fiscal periods substantially coincident with the owning or controlling company may, in respect of all such companies which carry on business in Canada, elect, before the commencement of the earliest fiscal period of any of the constituent companies in respect of which consolidation is desired, to file a return in which its profits or loss is consolidated with that of all of its subsidiaries carrying on business in Canada. The taxable income under such consolidated returns are taxed at the rate of 17% instead of 15%."

(Subsection 3 of Section 35.)

Great Britain

Income Tax

a) Intercorporate dividends.

All dividends received having borne income tax paid by the distributing company are exempt from any further income tax.

b) Privilege to file consolidated returns.

National Defense Contribution (1937)

a) Intercorporate dividends.

Dividends received from a company which is liable to be assessed to the Nat. Def. Contr. are not subject to another assessment under this tax.

(This at least seems to be the essence of the rather complicated Para. 7 of the Adaptations Schedule of the National Defense Contribution.)

b) Privilege to file consolidated returns.

A corporation owning at least 90% of the stock of another or several corporations can elect to file consolidated returns. (National Defense Contribution, Sec. 22.)

United States

a) Intercorporate dividends.

A domestic corporation may deduct 85% of the dividends received from another domestic corporation which has paid taxes upon its profits, but the amount deducted must not be in excess of 85% of the adjusted net income.

(Federal Revenue Act of 1938, Sec. 26.)

b) Privilege to file consolidated returns.

Corporations owning directly at least 95% of common stock of at least one company in a chain of subsidiaries have the option to file consolidated returns. Carriers have this option without qualification as to the ratio of owned to total stock of their subsidiaries.

"An affiliated group of corporations shall have the privilege of making a consolidated return for the taxable year in lieu of separate returns." Affiliated group "means one or more chains of corporations connected through stock ownership with a common parent corporation if—

(1) At least 95 per centum of the [common] stock of cash of the corporations (except the common parent corporation) is owned directly by one or more of the other corporations; and

(2) The common parent corporation owns directly at least 95% of the [common] stock of at least one of the other corporations; and

(3) East of the corporations is either (A) a corporation whose principal business is that of a common carrier by railroad or (B) a corporation the assets of which consist principally of stock in such corporations and which does not itself operate a business other than that of a common carrier by railroad. . . ." The term "railroad" includes street, suburban and interurban electric railway and bus lines, if operated by railway enterprises.

(Federal Revenue Act of 1938, Sec. 141.)

France

a) Intercorporate dividends.

Dividends received by a domestic parent corporation from nominative shares of a subsidiary company registered in the name of the former are exempt from the tax on income from movable capital, if the parent company owns at least 50% of the stock capital of the subsidiary company.

Dividends received by the parent company from shares of a subsidiary company are exempt from the "taxe du revenu des capitaux mobiliers", if the following requirements are fulfilled:

(a) The parent company (société mère) must be domestic and must be established under the form of a joint stock company (société par actions) or of a limited liability company (société à responsabilité limitée).

(b) The controlled company (Société filial) have to have one of the two forms prescribed for the parent companies (see (a)). It need not be domestic.

(c) The shares of the controlled company owned by the parent company must be nominative and registered in the name of the latter company. The shares must have been remitted under this form from the date of issue on.

(d) The shares of the controlled company owned by the parent company must represent at least half of the former's total capital.

(e) The "*taxe du revenu des capitaux mobiliers*" must have been paid by the controlled company.

Source: Pierre Baudovin-Bugnet: *Guide Fiscal des Sociétés Françaises.* Paris 1931, pp. 127 f.

Germany

a) Intercorporate dividends.

Dividends received by a corporation from another company which has paid taxes upon its profits are exempt from the corporation tax, if the former owns at least 25% of the latter's capital. Both companies must be fully taxable ("*Unbeschraenkt steuerpflichtig*").

(Corporation Tax Law of Oct. 16, 1934.
Para. 9, *Reichsgesetzblatt* 1934, pt. I, p. 1031).

b) Privilege to file consolidated returns.

2. *Carry-over of losses permitted in 1938.*

Great Britain

a) *Income tax:* from the second until the seventh year after the loss.

Operating losses may be carried over and set off against assessable profits in the six following years of assessment.
(Finance Act, 1918, Sec. 34, and Finance Act, 1926, Sec. 33.)

Sec. 19 of Finance Act, 1932 permits a further carry-over beyond the 6 years operating losses from one accounting period to the other, if any unexpired allowance for wear and tear (which must first be set off against subsequent profits in priority to losses) has operated to prevent the off-setting of a loss against subsequent profits.

b) *National Defense Contribution:* through all the five accounting periods of the law.

Previous operating losses may be carried over into any of the five accounting periods relevant for the purposes of the new National Defense Contribution tax, and deducted therein. Losses arising newly in any of the five accounting periods may be carried over into the next and ensuing relevant accounting periods. There is also made a provision for continuous carry-over of unexpired wear and tear arising prior to the first accounting period under the new tax.
(National Defense Contribution, Fourth Schedule, Adaptations of Income Tax Provisions as to Computations of Profits. Par. 2 and 3.)

United States

Till the second year after the loss, inclusive.

The amount of the net operating loss of the corporation may be carried over to the succeeding year, but the deducted amount must not be in excess of the adjusted net income of the taxable (i. e. succeeding) year.
(Federal Revenue Act, 1938, Sec. 26.)

France

Till the fifth year, inclusive.

Art. 7 of the 1938 Budget Law provides that losses may be carried forward and applied against profits over a period of five years.
(*Bulletin de Statistique et de Legislation Comparée,* Jan. 1938, p. 46.)

Germany

Losses sustained during two-year period prior to the assessment of incomes for the year 1938.

The old provisions of the Income Tax law allowing carry-over of losses, abolished in 1934, but reinstated by Art. I of the Amending Income Tax Law of Feb. 1, 1938, is apparently applicable also to the Corporation Tax Law.

(See *Richtinien fuer die Veranlagung zur Einkommensteuer und Koerperschaftssteuer fuer 1937* of Feb. 15, 1938. *Einfuehrung* (R. St. Bl., p. 193.)

APPENDIX NUMBER TWO

A Brief Description of Federal Taxes on Corporations Since 1861

WILLIAM A. SUTHERLAND

The cost to the federal government of financing the civil war created a need for increased revenue and congress in seeking new sources of revenue tapped thertofore untouched corporate and individual profits. The act of July 1, 1862, amending the act of August 5, 1861, is considered to be the basis of our present system of taxation and is the first law under which any federal income tax was collected.[1]

The tax acts of the civil war period[2] contained provisions imposing graduated taxes upon the gain, profits, or income of every person[3] and providing that corporate profits, whether divided or not, should be taxed to the stockholders.[4] Certain specified corporations were taxed under different provisions and stockholders of these corporations were not required to include in income their pro rata share of the profits of such corporations.[5] There were several tax acts during and following the war, but a description of the act of 1864 will serve to show the general extent of the corporate taxes of that period. The tax or "duty" was imposed upon all persons at the rate of 5% of the amount of gains, profits and income in excess of \$600 and not in excess of \$5,000, 7½% of the amount in excess of \$5,000 and not in excess of \$10,000, and 10% of the amount in excess of \$10,000.[6] Dividends were included in taxable in-

[1] Codification of Internal Revenue Laws published pursuant to Section 1203(c) of the Revenue Act of 1926, p. xl.

[2] Act Aug. 5, 1861, c. 45, §§ 49-51, 12 Stat. 309, which was amended, continued in force, and modified by act July 1, 1862, c. 119, §§ 89-93. 12 Stat. 473, act June 30, 1864, c. 173, §§ 116-123, 13 Stat. 281, act March 3, 1865, c. 78, 13 Stat. 469, act July 13, 1866, c. 184, § 9, 14 Stat. 101, act March 2, 1867, c. 169, § 13, 14 Stat. 477, and act July 14, 1870, c. 255, §§ 6-17, 16 Stat. 257. It expired in 1871. (References will be to act of 1864 even though similar provisions are contained in other acts of this period.)

[3] The definition of "person" was expressly made to include corporations except where otherwise stated or when "manifestly incompatible" with the provisions in which it was used. See sec. 82, act of 1864. However, it does not appear that any attempt was made to subject corporations to this tax.

[4] Sec. 117.

[5] Secs. 116, 117.

[6] Sec. 116. (Before any tax was collectible under this act, it was amended by the act of 1865, making the rates of tax 5% on incomes over \$600 and not over \$5,000 and 10% on the excess over \$5,000. 13 Stat. 479.)

come.[7] This tax was continued through the year 1871, but in the last two years of its existence, was reduced to 2½% upon all income.[8]

Upon the specified corporations referred to above, there was imposed a "duty" of 5% upon gain, profit and income.[9] The duty was not imposed directly upon net income as is the method today, but it was imposed upon interest or dividends paid out of "earnings, income, or gains," and upon amounts expended out of gains or profits for construction or added to any fund or undistributed sums representing profits. A corporation paying the 5% "duty" on interest or dividends was authorized to withhold this tax from interest or dividends paid so that only with respect to undistributed gains or profits was the tax burden placed upon the corporation. These provisions applied to banks, trust companies, insurance companies, railroad companies, canal and other similar transportation companies. Double taxation with respect to the profits of these corporations was avoided by providing that a person subject to the income tax should have a deduction from income of the amount of interest and dividends received from such specified corporations.[10] The provisions imposing this duty or tax upon the specified corporations were repealed in the act of 1870.[11]

Under a joint resolution passed by congress in 1864, there was retroactively imposed for the year 1863 an additional income tax of 5%.[12] All persons were subject to this tax, no exemptions being allowed, nor was there any deduction given for dividends or interest received from the specified corporations who, under the act of 1862, had already paid a 3% "duty" on such dividends or interest.[13] None of these civil war taxes was found by the supreme court to be unconstitutional, although the case of *Brainard* v. *Hubbard*, 12 Wall. (U. S.) 1, 20 L. ed. 272, upholding Sec. 117 of the act of June 30, 1864, as amended by the act of March 3, 1865, was disapproved in a later supreme court case.[14]

In 1894 there was imposed another income tax, this time upon corporations and individuals alike, at the rate of 2% of gains, profits,

[7] Sec. 116.

[8] Sec. 6, act of 1870.

[9] Secs. 120, 122, act of 1864.

[10] Sec. 117.

[11] Sec. 17, act of 1870.

[12] See Jt. Res. (No. 77), July 4, 1864, 13 Stat. 417.

[13] Secs. 81, 82, Act of 1862.

[14] Eisner v. Macomber, 252 U. S. 189, 218 64 L. ed. 521, 533. See other cases discussing these statutes: Stockdale v. Atlantic Ins. Co., 20 Wall. 323, 22 L. ed. 348; Michigan Cent. R. Co. v. Slack, 100 U. S. 595, 25 L. ed. 647; Springer v. U. S., 102 U. S. 586, 26 L. ed. 253; U. S. v. Erie R. Co., 106 U. S. 327, 27 L. ed. 151.

or income, from whatever source obtained.[15] A $4,000 credit against income given to individuals was not extended to corporations.[16] There was excluded from the income of any person or corporation dividends received from any corporation, company or association, "if the tax of 2% has been paid upon its net profits by said corporation . . ."[17] By the joint resolution of February 21, 1895, such dividends were excluded from income where paid by any corporation, company or association which was subject to the tax of 2% upon net profits, even though no tax may have been paid.[18] Certain classes of charitable, religious or educational corporations, building and loan associations, savings banks and insurance companies conducting business upon the mutual plan, were exempted from the tax.[19] This tax was held unconstitutional by the supreme court in so far as it laid a tax on the rents or income from real estate and personal property, on the grounds that it was a direct tax requiring apportionment under Art. I, Sec. 2 of the constitution, providing that direct taxes be apportioned among the several states, and, in so far as it laid a tax upon the income derived from municipal bonds, on the grounds that this was repugnant to the constitution of the United States as a tax upon the power of the states and their instrumentalities to borrow money.[20] The income tax provisions being invalid as to the greater part of the intended sources of income, they were held by the court to be wholly inoperative and void.

Again in 1909, congress in the Payne-Aldrich Tariff Act imposed what looked suspiciously like an income tax upon corporations.[21] The tax was carefully referred to, however, as a "special excise tax with respect to the carrying on or doing business," and was at the rate of 1% upon the entire net income, exceeding $5,000, of every corporation, joint stock company and association organized for profit and having a capital stock represented by shares.[22] There were excluded from "net income," dividends received from other corporations subject to the tax.[23] This tax was in effect for the years 1909 through 1912, and by the act of 1913 was continued in effect for the first two months of that year.[24] The constitutionality of the act of 1909 was upheld by the supreme court.[25]

[15] Act of Aug. 27, 1894, c. 349, secs. 27-37, 28 Stat. 553.

[16] Sec. 28, 32. [17] Sec. 28.

([18] Jt. Res. (No. 18), 28 Stat. 971.

[19] Sec. 32.

[20] Pollock v. Farmers Loan & Trust Company, 157 U. S. 429, 39 L. ed. 759; 158 U. S. 601, 39 L. ed. 1108.

[21] Act, Aug. 5, 1909, c. 6, 36 Stat. 112.

[22] Sec. 38. [23] Sec. 38.

[24] Act, Oct. 3, 1913, c. 16, § IV, par. S, 38 Stat. 114, 202.

[25] Flint v. Stone Tracy Company, 220 U. S. 107, 55 L. ed. 389.

The sixteenth amendment, adopted February 25, 1913, provided that "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." This amendment gave to congress the *power*, and only a few years later the World War gave to congress the *need* to levy tremendous undisguised income taxes upon individuals as well as corporations. As rates applying to both individuals and corporations were increased, greater care was taken to reach those gains and profits considered to be properly taxable and to insert remedial provisions where general provisions otherwise operated harshly and not in accordance with the intent of congress. Attempts were made to prevent the use of the corporate form to enable the shareholders to avoid high taxes upon their individual incomes. "Excess" profits were especially singled out for attention during and immediately following the war. In subsequent Acts, other types of income have been given special attention. All of this has resulted in revenue acts that are long and complicated and present a patchwork of cross references and technical terms, requiring careful and analytical study.

The revenue act of 1913 which was passed on October 3, 1913 and was applicable for the period from March 1st of that year to December 31, 1915, was the first act passed under the sixteenth amendment. It imposed upon corporations a tax at the flat rate of 1% of net income.[26] No exemption such as the $5,000 exemption in the act of 1909 was given. Net income was defined very much as it was under the act of 1909. Provisions exempting certain non-profit organizations were also substantially the same.[27]

In drafting the revenue act of 1913, the legislators anticipated and attempted to prevent a type of tax avoidance which has been a constant problem to congress ever since. That act prescribed that the income of individual shareholders should include their pro rata share of the net income of corporations "formed or fraudulently availed of" for the purpose of preventing the imposition of the surtax, or "additional tax" as it was then called, upon individuals by means of accumulating the gains and profits of such corporations and not distributing them.[28] The fact that a corporation was a "mere holding company" or that gains and profits were permitted to accumulate beyond the reasonable needs of the business was made prima facie evidence of a fraudulent purpose.

The act of 1913 exempted corporate dividends from the net income of individuals for normal tax purposes, but not for "additional

[26] Sec. II, par. G(a).

[27] Sec. II, par. G(a).

[28] Sec. II, par. A(2).

tax" purposes.[29] This exemption was not given to corporations. It is to be noted that in this act,[30] as well as in the 1916 act,[31] normal rates on corporations and individuals were the same. The "additional tax" was not imposed upon corporations.

Little change was made in the revenue act of 1916 as it applied to corporations, except that the rate of tax was increased to 2%.[32] The normal tax rate on individuals was likewise made 2%, and, for the purposes of the normal tax on individuals, dividends were excluded.[33] The requirements of the prior act that for surtax purposes individuals include the undistributed profits of corporations fraudulently availed of to avoid such taxes were retained.[34]

The corporate tax rate of 2% contained in the 1916 act was made applicable to the year 1917 by the 1917 act which was passed as an amendment to the act of 1916.[35] An additional tax of 4% on net income less dividends received was imposed upon corporations.[36] Here the identity between the rate of the corporate income tax and the rate of the normal tax on individuals disappeared and in all subsequent acts the corporate rate has exceeded the normal rate for individuals. From corporate income there could be deducted for income tax purposes the amount of excess-profits tax imposed for the same year.[37]

The 1917 act contained a provision placing on every corporation, joint stock company or association, or insurance company a tax of 10% of the amount of the total net income received during the year which remained undistributed six months after the end of the taxable year. The tax was not made to apply to that portion of undistributed net income actually invested or employed in business or retained for employment in the reasonable requirements of the business or invested in obligations of the United States issued after September 1, 1917.[38]

The 1917 act provided that distributions by corporations in 1917 and later years should be deemed to have been made from the most recently accumulated profits and should constitute income to the distributee for the year in which received, but "shall be taxed to the distributees at the rate prescribed by law for the years in which

[29] Sec. II, par. B.

[30] Sec. II, par. G(a).

[31] Act of Sept. 8, 1916, Secs. 1(a), 10, Tit. I, c. 463, 39 Stat. 756, 765.

[32] Sec. 10.

[33] Sec. 5(b).

[34] Sec. 3, act of 1916.

[35] Act of Oct. 3, 1917, sec. 1206 (1), c. 63, Tit. XII, 40 Stat. 300, 333.

[36] Sec. 4.

[37] Sec. 1211.

[38] Sec. 1206 (2).

such profits or surpluses were accumulated by the corporation . . ." [39] This marked the first legislative attempt to designate the source and nature of corporate distributions.

In the revenue act of 1918,[40] which was in effect through 1920, the income tax on corporations was imposed at largely increased rates, namely, 12% for the year 1918 and 10% for subsequent years.[41]

As is usually the case, with increased taxes came additional provisions intended to eliminate inequities which become more apparent and more onerous with a heavier tax. The provisions as to the filing of consolidated returns by affiliated corporations, made applicable by Article 78 of Regulations 41 under the 1917 act only for excess-profits tax purposes, were written into the 1918 act and made applicable for income tax purposes, as well as for excess and war-profits tax purposes.[42] Certain corporations were excluded from consideration as affiliated corporations where their chief income arose from contracts made while the United States was engaged in war with Germany. Provision was also made that the net loss suffered in any year beginning after August 31, 1918, and ending prior to January 1, 1920, arising from a trade or business or from the sale of facilities acquired during the war for the purpose of contributing to the prosecution of the war, should be applied to reduce net income in the preceding year, and if in excess of that income, to reduce to the extent of the excess the net income also of the succeeding year.[43] Corporations were not taxed for either income or war-profits and excess-profits tax purposes upon dividends from other corporations subject to these taxes.

An important addition to income tax law was the new provision for non-recognition of gain or loss upon an exchange of stock or securities for new stock or securities of no greater aggregate face or par value, where the exchange occurs in connection with a reorganization, consolidation or merger.[44] When the aggregate par or face value of the new stock was in excess of that of the old stock, the excess was treated as gain to the extent that the fair market value of the new stock exceeded the cost or March 1, 1913 value of the old stock. In later acts, considerable attention has been given to provisions making tax-free exchanges possible in reorganizations, consolidations and mergers.

Sec. 218 (e) of the 1918 act introduced another new measure into tax law. It provided for the taxation of the income of personal

[39] Sec. 1211.

[40] Act Feb. 24, 1919, c. 18, Tit. II, 40 Stat. 1058.

[41] Sec. 230(a) (1) and (a) (2).

[42] Sec. 240(a).

[43] Sec. 204.

[44] Sec. 202(b).

service corporations to the members of the corporations in their individual capacities, to the extent of the distributive share of each in the net income of the personal service corporation. A personal service corporation was defined as a corporation whose income was obtained chiefly from the activities of the principal owners or stockholders who themselves were active in the business and whose capital was not a material income-producing factor.[45] Personal service corporations, the income of which was taxed to their shareholders, were not themselves subject to the income tax [46] or to the war-profits and excess-profits taxes.[47] This special treatment of personal service corporations was continued in the revenue act of 1921 but has not been contained in any later act.[48]

Provisions taxing to stockholders the profits of corporations formed or availed of for the purpose of preventing the imposition of the surtax upon individual stockholders were continued substantially as in earlier acts.[49]

Of far greater effect upon corporations than any of the other provisions of the acts of 1917 and 1918 which have been mentioned are those prescribing excess-profits and war-profits taxes.[50] The excessiveness of the profits was determined in part by comparing such profits with the annual profits made during a selected period prior to the beginning of the World War, and in part by reference to certain arbitrary rates of return on invested capital which were assumed to be "normal". Inter-corporate dividends were excluded from income.[51]

The war-time excess-profits tax was imposed, in addition to other taxes, on corporations, partnerships, and individuals for the year 1917, and on corporations alone for the years 1918 through 1921.[52] The war-time excess-profits tax on corporations was imposed at increasing rates on incomes falling within certain percentages of the "invested capital".[53] There was a credit allowed against net income of $3,000 plus a certain rate of return on invested capital.[54] (The prescribed rate of return on invested capital was called a

[45] Sec. 200.

[46] Sec. 231 (14).

[47] Sec. 304(a).

[48] Act Nov. 23, 1921, c. 136, Tit. II, 42 Stat. 227.

[49] Sec. 220.

[50] Act of 1917, Tit. II, act of 1918, Tit. III. An excess-profits tax imposed by the act of March 3, 1917. C. 159, 39 Stat. 1,000, was superseded by the act of Oct. 3, 1917, Sec. 214 of this act expressly repealing the excess-profits tax provisions of the earlier act.

[51] Sec. 206, act of 1917, sec. 320, acts of 1918, 1921.

[52] Sec. 201, act of 1917, sec. 301 (a), (b), act of 1918, sec. 301 (a), act of 1921.

[53] Sec. 201, act of 1917, sec. 301, acts of 1918, 1921.

[54] Sec. 203 (a), act of 1917. Sec. 312, acts of 1918, 1921.

"deduction" in sec. 203 of the 1917 act.) Under the 1917 act, a corporation was allowed as a return upon its "invested capital" the same rate of return obtained in the "prewar" years of 1911 through 1913, provided that the rate of return was not less than 7% nor more than 9%.[55] For example, if a concern with an invested capital in the "prewar" period, as well as in the taxable year, of a million dollars earned in the "prewar" period an average return of 9%, its credit for the taxable year would be $3,000 plus 9% of its invested capital for the taxable year, or $90,000. The net income in excess of the $93,000 would be subject to the excess-profits tax. The computation of net income during the "prewar" years was made as prescribed under the revenue acts for those years, that is, under the act of 1909 for the years 1911 and 1912 and under the 1913 act for the year 1913.[56] A complicated definition was given of the meaning of "invested capital."[57] Under the 1918 and 1921 acts, no use was made of the "prewar" period for excess-profits tax purposes, and a credit is provided of $3,000 plus 8% of the "invested capital" for the taxable year.[58]

The excess-profits tax for the taxable year 1917 was imposed at the following rates: 20% of the amount of net income in excess of the deduction and not in excess of 15% of the invested capital; 25% of the amount in excess of 15% of the invested capital and not in excess of 20%; 35% of the amount in excess of 20% and not in excess of 25%; 45% of the amount in excess of 25% and not in excess of 33%; and 60% of the amount of net income in excess of 33% of the invested capital.[59] Under the 1918 act, the tax was increased for the year 1918 to 30% of the amount of net income in excess of the excess-profits credits and not in excess of 20% of the invested capital; and 65% of the amount of net income in excess of 20% of the invested capital.[60] For the years 1919,[61] 1920,[62] and 1921,[63] the excess-profits tax was reduced from the 30% and 65% rates in effect for the year 1918 to 20% and 40%.

Provision was made in the 1917 act to cover cases where the return of a corporation during the "prewar" years was abnormally low.[64] It was provided that in such cases, under regulations prescribed by the commissioner of internal revenue, the deduction of a

[55] Sec. 203 (a) (e).

[56] Sec. 206, act of 1917.

[57] Sec. 207, act of 1917, sec. 326, acts of 1918, 1921.

[58] Sec. 312, acts of 1918 and 1921.

[59] Sec. 201.

[60] Sec. 301 (a).

[61] Sec. 301 (b), act of 1918.

[62] Sec. 301 (b), act of 1918.

[63] Sec. 301 (a), act of 1921.

[64] Sec. 205.

corporation should constitute the same percentage of its invested capital for the taxable year as the deduction of representative concerns bore to their invested capital for the year.

With a few additional specifications, the same corporations, normally exempted from income tax, were also exempted from excess-profits taxes.[65] Under the 1917 act a corporation engaged in a trade or business having no invested capital or not more than a nominal capital was not subjected to the excess-profits tax, but was subject, in addition to other taxes, to a tax of 8% of its net income in excess of $3,000.[66]

It was no doubt realized that it would be impossible satisfactorily to ascertain "invested capital" in many cases, and consequently a section was inserted giving the commissioner the authority to prescribe for a corporation in such a position that its deduction from net income for excess-profits tax purposes should be the same percentage of its net income as the deduction of representative concerns for the same year bore to their income.[67] Similar treatment was extended in the 1918 and 1921 acts to corporations which were able to show to the satisfaction of the commissioner that the tax if determined without giving the corporation the benefit of such relief would, due to abnormal conditions affecting the capital or income of the corporation, work an exceptional hardship upon the corporation.[68] Great discretion here was left to the commissioner to determine first, what corporations were entitled to the benefit of "special assessments", and second, what concerns should be chosen as "representative concerns" under the act.

Another war-time tax closely associated with the war-time excess-profits tax is the war-profits tax imposed with the usual exemptions upon all corporations generally for the year 1918,[69] and imposed for the years 1919 through 1921 and upon net incomes of corporations in excess of $10,000 derived from government contracts made between April 6, 1917 and November 11, 1918.[70] As already mentioned, personal service corporations were not subject to this tax.

The war-profits tax was equal to the sum by which 80% of net income in excess of the war-profits credit exceeded the excess-profits tax for the taxable year.[71] The credit amounted to $3,000 plus the average net income for the "prewar years" with an adjustment for the difference between the "average invested capital" of the "prewar" period and the taxable year, provided that the credit for

[65] Sec. 201, act of 1917; sec. 304, acts of 1918, 1921.

[66] Sec. 209.

[67] Sec. 210, act of 1917; sec. 327, acts of 1918, 1921.

[68] Sec. 327, acts of 1918, 1921.

[69] Title III, act of 1918.

[70] Sec. 301 (c), act of 1918; sec. 301 (b), act of 1921.

[71] Sec. 301 (a), act of 1918.

return on "invested capital" should not be less than 10% of the "average invested capital" for the year.[72] In short, a corporation was given a credit against net income of $3,000, plus what it might have been expected to earn in the taxable year judging by its earnings in a comparative period, but not less than 10% of the "invested capital", and all over that was subjected to the highly confiscatory tax of 80% with a deduction being given for the excess-profits tax.

The 1918 and 1921 acts provided for the separate computations of the excess-profits and war-profits taxes and a division of the net income of the corporation where a portion of it was derived from a trade or business which, if taken alone, would permit the corporation to qualify as a personal service corporation.[73]

The war tax acts provided that a corporation should be considered as having continued in existence during the "prewar" years in spite of any reorganization which took place,[74] and, in the event of a reorganization after March 3, 1917, prohibited an increase in value of capital for the purpose of ascertaining "invested capital" where there was not a real purchase of property in any sale or exchange in which 50% of the interest or control of the property remained in the same person.[75]

A war-profits tax was continued for the years 1919, 1920 and 1921 only where a net income of $10,000 or more was received from contracts made with the government during the war.[76] The amount of the tax was obtained for those years by taxing the total net income at the rates provided for all corporations under the excess-profits and war-profits tax provisions of the 1918 act and taking as the amount of the tax due that percentage of the total tax obtained in this manner which the net income from the government contracts bore to the entire net income.[77]

There was imposed by the revenue act of 1918 and continued by the revenue acts of 1921 and 1924,[78] a capital stock tax at the annual rate of $1.00 for each $1,000 of the "fair average value" of the capital stock of the taxpayer in excess of $5,000.00.[79] The surplus and undivided profits were to be included in estimating the average value of capital stock.[80] The capital stock tax was in

[72] Sec. 311, act of 1918.

[73] Sec. 303, acts of 1918, 1921.

[74] Sec. 204, act of 1917; sec. 330, act of 1918.

[75] Sec. 208, act of 1917; sec. 331, acts of 1918, 1921.

[76] Sec. 301(c), act of 1918; sec. 301(b), act of 1921.

[77] Sec. 301(a), act of 1918; sec. 301(b), act of 1921.

[78] Act of June 2, 1924, c. 234, 43 Stat. 253.

[79] Sec. 1000, acts of 1918, 1921; sec. 700, act of 1924.

[80] Sec. 1000(a) (1), acts of 1918, 1921; sec. 700(a) (1), act of 1924.

effect until repealed by the revenue act of 1926 [81] and after that did not appear again until associated with the excess-profits tax in the National Industrial Recovery Act of June 16, 1933.[82]

After the war was over, and the war period passed, it was the general tendency of tax acts, beginning with the 1921 act and continuing through the 1928 act,[83] to reduce taxes from what they had been during the war and to improve the revenue acts, not by any startling changes, but by remedial provisions intended to eliminate any harsh effect of existing provisions and also intended to prevent tax avoidance. The revenue of the national government was high in relation to its expenses, and the difficulties of bringing the budget of the federal government into balance were not serious.

The corporate income tax as imposed by the revenue act of 1918 for the years 1919 and 1920 was not materially changed by any subsequent acts during the "Twenties". That tax under the 1918 act was at the rate of 10% of net income in excess of credits, including a $2,000 credit.[84] Under the 1921 act, the rate continued the same for that year [85] and was increased to 12½% for 1922 and 1923, to offset in part the loss in revenue upon the abandonment of the excess-profits tax.[86] Under the 1921 act and the acts of 1924 and 1926 the credit of $2,000 was given only to corporations having incomes less than $25,000 with provisions for adjustment where incomes were slightly in excess of $25,000.[87] Under the revenue act of 1924, the rate remained at 12½%,[88] but under the revenue act of 1926, was increased to 13% for the year 1925 [89] and to 13½% for the years 1926 and 1927.[90] The $2,000 credit was continued. Under the 1928 act,[91] the specific credit to corporations with net incomes less than $25,000 was increased to $3,000 and the rate decreased to 12% for the year 1928,[92] and by resolution of congress further decreased to 11% for the calendar year 1929.[93] The rate for the years 1930 and 1931 was 12% under the 1928 act.

In the revenue acts from 1921 to the present time, the simple statement in the revenue act of 1918 providing for non-recognition

[81] Act of Feb. 26, 1926, c. 27, 44 Stat. 10.
[82] Secs. 215, 216, c. 90, 48 Stat. 207.
[83] Act of May 29, 1928, c. 852, 45 Stat. 791.
[84] Sec. 230(a) (2).
[85] Sec. 230(a).
[86] Sec. 230(b).
[87] Sec. 236(b), Acts of 1921, 1924, 1926.
[88] Sec. 230.
[89] Sec. 230(a) (1).
[90] Sec. 230(a) (2).
[91] Sec. 13.
[92] Sec. 13(a).
[93] Res., Dec. 16, 1929, c. 2, Sec. 1, 46 Stat. 47.

of gain or loss upon the exchange of stock for stock of no greater aggregate or par value in a merger, consolidation, or reorganization has been amplified and greatly extended. There have been two reasons for the continued attention which reorganizations have received in the drafting of these acts. One has been the desire to extend the benefits of non-recognition of gain or loss to those transactions where in practical effect there was either a mere rearrangement of evidences and types of ownership without any change in the fact of ownership and thing owned or a merger of ownership without any immediate realization of gain. The other has been to eliminate the possibility of the reorganization provisions being availed of to realize free from tax real and not merely fictional gains. Some idea of the extent of this development can be obtained by an inspection and comparison of the reorganization provisions of the 1918 act and those of recent acts.

In the 1921 act, a new type of provision was made to prevent the misuse of corporations to evade surtaxes on individuals.[94] Upon corporations formed or availed of for the purpose of evading surtaxes, it placed a tax, in addition to normal tax, of 25% of net income. The presumptions as to holding companies and unreasonable accumulation of profits were similar to those in earlier acts. However, where all stockholders of a corporation subject to the tax of 25% agreed, the commissioner, in lieu of all other taxes, income, war-profits and excess-profits taxes, could tax the stockholders on their distributive share of the net income of the corporation. In the revenue act of 1924 the tax was increased upon the net income of a corporation availed of to prevent the imposition of surtax on its shareholders from 25% of the net income to 50%, and to net income was added the amount of the dividends received from domestic corporations and otherwise allowed as a deduction.[95] No provision was made for the reporting of corporate income by the stockholders. The tax was retained at the same rate in the revenue act of 1926 with the privilege being given to shareholders to relieve the corporation from this tax by electing to report as income to themselves their entire distributive share, whether distributed or not, of the net income of the corporation for such year.[96] Amounts so included by shareholders in their income were to be treated as dividends received. These provisions were continued in substantially the same form in the revenue act of 1928.[97]

Attention was given in these revenue acts to the treatment of dividends paid by corporations. After the case of *Eisner* v. *Ma-*

[94] Sec. 220.
[95] Sec. 220.
[96] Sec. 220.
[97] Sec. 104.

comber,[98] a provision was contained in the 1921 act to the effect that a stock dividend was not taxable, but that a cancellation or redemption of dividend stock after its issuance which made its issuance substantially equivalent to a taxable dividend should be treated as such.[99] This section was changed slightly in the 1924 act in order to provide that any cancellation or redemption of dividend stock *before or after* the issuance of the stock dividend in such manner as to be essentially equivalent to the distribution of a taxable dividend should be treated as such.[100] Further addition was made in the act of 1926 by the requirement that there be treated as a taxable dividend any amount substantially equivalent to a taxable dividend distributed by a corporation in redemption or cancellation of its stock, whether or not such stock was issued as a stock dividend.[101]

The matter of consolidated returns filed by affiliated corporations received considerable attention following the war. After the passage of the war-profits tax in 1917, a committee working upon the drafting of the rules and regulations to carry out the act recommended to the treasury department, and the recommendation was accepted, that corporations which were affiliated in such a way as to constitute in actual effect only one corporation be required to file a consolidated return whenever it was found by the commissioner of internal revenue to be necessary in order to more equitably determine the invested capital or taxable income." [102] In the 1918 act, it was made mandatory that all corporations affiliated within the meaning of the act file consolidated returns.[103] Under the revenus acts of 1921, 1924 and 1926, the filing of such returns was made optional with the corporations.[104] The act of 1928 continued this privilege for the year 1928,[105] but attached the condition to the grant of the privilege for 1929 and subsequent years that the corporation agree to accept all regulations prescribed by the commissioner for 1929 and subsequent years which were to be drawn up for the purpose of insuring that the income of consolidated corporations both during the period of consolidation and in subsequent years should be clearly reflected and that tax liability should not be avoided.

[98] 252 U. S. 189, 64 L. ed. 521, decided March 8, 1920.

[99] Sec. 201(d).

[100] Sec. 201(f).

[101] Sec. 201(g).

[102] Reg. 41, Art. 78.

[103] Sec. 240.

[104] Sec. 240, acts of 1921, 1924, 1926.

[105] Sec. 141.

In the revenue act of 1932,[106] there was a slight increase in the rate of taxation from 12% under the then existing law to 13¾%.[107] No credit such as that for $3,000 under the 1928 act was granted.[108]

There was set up under the 1932 act a new title entitled "Tax on Transfers to Avoid Income Tax."[109] Under this title, the transfer of stock or securities by a domestic corporation, as well as by an individual, a partnership or a domestic trust, to a foreign corporation, trust or partnership as paid-in surplus or contributions to capital, was taxed at the rate of 25% upon the excess of the value of the stock over its basis in the hands of the transferror. This transfer tax was not to apply if the transferee was an organization exempted from tax under the provisions of the act exempting specified non-profit organizations, or if prior to the transfer it was established to the satisfaction of the commissioner that the transfer was not made in order to avoid income tax. This tax is still in effect.[110]

Provisions as to the filing of consolidated returns by affiliated corporations were continued in the revenue act of 1932 but an additional income tax of ¾ of 1 percent was placed on corporations electing to file returns on a consolidated basis.[111] The 50% tax upon the net income of corporations formed or availed of for the purpose of accumulating surplus in order to prevent the imposition of surtaxes upon shareholders of the corporation was also retained.[112]

The revenue act of 1932 was applicable to the year 1932 and, as amended by the National Industrial Recovery Act of June 16, 1933, to the year 1933 as well. The principal change in the National Industrial Recovery Act with which we are concerned here relating to the corporate income tax was the withdrawal of the deduction allowed under prior acts for net losses incurred in the preceding year.[113] Under the 1932 act, a one year carry-over of net losses had been permitted which was a change from the 1928 and prior acts permitting a carry-over of two years.[114]

The N. I. R. A. reintroduced to corporate taxation the capital stock and excess-profits taxes, but they were entirely different in many respects from similarly named taxes of prior years. A capital

[106] Act of June 6, 1932, c. 209, Tit. I, 47 Stat. 173.

[107] Sec. 13(a).

[108] Sec. 26, acts of 1928, 1932.

[109] Title VII, Secs. 901-904.

[110] Chapter 7, p. 154, Codification of Internal Revenue Laws.

[111] Sec. 141.

[112] Sec. 104.

[113] Sec. 218(a).

[114] Sec. 117(b), acts of 1932, 1928; sec. 206(b), acts of 1926, 1924; sec. 204(b), act of 1921.

stock tax was imposed at the rate of $1.00 for each $1,000, not of the *actual* value of the capital stock, but for each $1,000 of *any* value which a corporation might choose to place upon its capital stock.[115] However, to insure the fact that no less than the normal rate of $1.00 upon each $1,000 of the fair value of the capital stock should be obtained, the excess-profits tax was imposed at the rate of 5% upon the net income of the corporation in excess of 12½% of the "adjusted declared value" of the capital stock.[116] The capital stock tax was applicable to each year ending June 30th, beginning with the year ended June 30, 1933; and the excess-profits tax was applicable to each taxable year ending after the close of the first year in respect of which the corporation was subject to the capital stock tax. It was provided in this act that a value declared in the first year should be retained for subsequent years with necessary adjustment for such things as distributions out of capital, additions to capital, paid-in surplus, profits or deficits, and exempted income. The usual class of non-profit organizations was excluded from the application of these provisions, as well as any corporation not doing any business during the year with respect to which these taxes were applied. In passing it may be noted that the life of the capital stock and excess-profits taxes under the N. I. R. A. was to be terminated by a proclamation of the president proclaiming the date of the end of the first fiscal year after the 1933 fiscal year in which the receipts of the federal government exceeded the expenditures, or the repeal of the eighteenth amendment to the constitution, whichever was earlier.[117] The repeal of the eighteenth amendment was proclaimed by the president on December 5, 1933.[118]

The 1934 act amended the capital stock tax and excess-profits tax provisions under the N. I. R. A. so that the former applied only to the year ended June 30, 1933 and the latter to taxable years ended prior to July 1, 1934,[119] and similar taxes were provided under the 1934 act for the following years.[120] The taxpayer was given the privilege of redeclaring the value of his capital stock for the year ended June 30, 1934.[121] As will be noted, the capital-stock and excess-profits taxes and the interdependency and relation between them has been continued in later acts to the present, the principal change being an increase in rates.

The N. I. R. A. placed a tax of 5% upon the receipt of dividends by any person other than a domestic corporation.[122] Dividends

115 Sec. 215.

116 Sec. 216.

117 Sec. 217(d) and (e).

118 Proclamation No. 2064, 48 Stat. 1720.

119 Sec. 703.

120 Secs. 701, 702.

121 Sec. 701(f).

122 Sec. 213(a).

subject to this tax were those required to be included in the gross income of the recipient under the provisions of the revenue act of 1932. The payor corporation was made a withholding agent and indemnified against claims of any person for the amount of any such payments made out of dividends.[123] This tax also was to continue in force until the end of the calendar year in which the president made the proclamation relating to either the excess of government receipts over expenditures or the repeal of the eighteenth amendment.[124]

The additional tax of ¾ of 1% placed upon corporations filing consolidated returns under the 1932 act was increased by the N. I. R. A. to 1% for the taxable years 1934 and 1935.[125]

In the revenue act of 1934,[126] the normal tax was imposed upon corporations at the same rate as that prescribed in the revenue act of 1932, namely 13¾%,[127] with the exception that in the case of consolidated returns of railroad corporations, the rate was made 15¾%.[128]

The privilege of making consolidated returns which had existed as a privilege since the 1921 act, and had been available to all corporations affiliated within the meaning of the acts since 1917 was limited under the new act to affiliated groups of corporations, each corporate member of which was either a corporation whose principal business was that of a common carrier by railroad, or a corporation holding stock in such a corporation and which did not itself operate a business other than that of a common carrier by railroad.[129] Since this privilege of filing consolidated returns was considered valuable and was not available to all corporations, corporations taking advantage of it were subjected to an income tax rate 2% higher than that applicable to other corporations.

Under the 1934 act, there was introduced a very important limitation upon the capital losses of all taxpayers, including corporations, excepting certain sales by banks or trust companies, of $2,000 plus gains from sales or exchanges of capital assets.[130]

Sec. 351 of the revenue act of 1934 is the culmination of the first of several outstanding efforts on the part of the present administration and the committees in the house of representatives and the senate, to which the tax bill goes for consideration, to eliminate what is termed as the inequity of the escape by individuals from

[123] Sec. 213(b) and (c).
[124] Sec. 217(c).
[125] Sec. 218(e).
[126] Act of May 10, 1934, c. 277, 48 Stat. 683.
[127] Sec. 13(a).
[128] Sec. 141(c).
[129] Sec. 141.
[130] Sec. 117(d).

surtaxes by means of the retention of corporate profits without distribution. It has been seen that this means of evading taxes was anticipated by those who drafted the first revenue act under the sixteenth amendment. Under that act, it was recognized that personal holding companies might be the chief offenders on this score, and so it was presumed that a holding company was formed or availed of for the purpose of evading surtaxes on individuals. This presumption has been retained in later acts, whether the acts treated such accumulated profits as if they were distributed and thus taxable to the shareholders, or attempted to force distributions and recoup taxes otherwise lost to the government by heavy taxes upon corporations found to have been formed or availed of for purposes of evading surtaxes upon individuals. For a corporation to be subject to the heavy taxes upon accumulations under these acts, intent to evade had always been a necessary condition and the difficulty of proving this intent greatly impaired the effectiveness of the act. With this in mind, those drafting the revenue act of 1934 imposed upon personal holding companies as defined in the Act a heavy surtax upon profits earned during the year and not distributed, and the intent responsible for these accumulations was immaterial, as personal holding companies were becoming popularly known as "incorporated pocketbooks", and the fact of their existence if accompanied by actual accumulations was, no doubt, considered sufficient evidence of the intent.[131]

The new surtax on personal holding companies was not imposed upon the "net income" of such corporations as net income was defined for purposes of the normal tax, but was imposed upon such net income, after certain additions and subtractions, resulting in an "undistributed adjusted net income."[132] The amount of dividends received from other domestic corporations not otherwise included in net income was added back, and the federal income, war-profits and excess-profits taxes paid or accrued during the year not otherwise deductible were permitted as deductions, as well as contributions or gifts not otherwise allowed as deductions because in excess of the limitation on the amount of charitable contributions, and losses from sales or exchanges of capital assets disallowed by reason of exceeding the $2,000 limitation upon capital losses.[133] The net income as thus adjusted in order to arrive at the true income which a corporation might be considered to have available for distribution was termed the "adjusted net income." It was thought that some retention of income should be permitted, and so there was allowed as a deduction from "adjusted net income," 20% of that portion of the "adjusted net income" not received as dividends from domestic

[131] Sec. 351.

[132] Sec. 351(a).

[133] Sec. 351(b) (3).

personal holding companies.[134] There was also permitted a deduction from "adjusted net income" for reasonable amounts used or set aside to retire indebtedness incurred prior to January 1, 1934,[135] and for dividends paid during the year.[136] The income remaining after these deductions was termed under the act the "undistributed adjusted net income," [137] and upon this income a tax was imposed at the rate of 30% of that portion of this income under $100,000, and 40% of that portion over $100,000.[138] Shareholders of a personal holding company were permitted to relieve the corporation from the application of this section by including in their gross income at the time of filing their returns their entire pro rata share of the "adjusted net income" of the corporation just as if dividends were paid to them equal to these amounts, and such amounts were to be taxable to the individual shareholders.[139]

A personal holding company for purposes of this surtax on "undistributed adjusted net income" was defined as being any corporation, other than certain banks or trust companies, life insurance or surety companies, or the normally exempted non-profit organizations, at least 80% of whose income for the year was derived from royalties, dividends, interest, annuities and (except in the case of regular dealers in stocks or securities) gains from the sale of stocks or securities, and 50% of whose stock was owned at any time during the last half of the taxable year, directly or indirectly, by not more than five individuals.[140] Stock owned directly or indirectly by a corporation, partnership, estate or trust was considered as being owned proportionately by its shareholders, partners, or beneficiaries, and an individual was considered as owning the stock directly or indirectly owned by his brothers and sisters, spouse, ancestors and lineal descendants. These provisions were made in order to measuure ownership only by the real owners of a personal holding company and to prevent distribution of stock in a family for the purpose of bringing the number of owners above five.

The surtax on corporations improperly accumulating a surplus and not distributing it was retained in the 1934 act with certain changes which, it was hoped, would make it more effective, since it had in the past been of little use.[141] Personal holding companies were excluded from the application of this tax. The rate at which the tax was imposed was changed from the flat rate of 50% which

[134] Sec. 351(b) (2) (A).
[135] Sec. 351(b) (2) (B).
[136] Sec. 351(b) (2) (C).
[137] Sec. 351(b) (2).
[138] Sec. 351(a).
[139] Sec. 351(d).
[140] Sec. 351(b) (1).
[141] Sec. 102.

had been in effect since 1924 to a tax of 25% of the amount of the "adjusted net income" not in excess of $100,000 plus 35% of the amount of the "adjusted net income" in excess of $100,000. This tax had formerly been imposed upon "net income" as defined for purposes of the normal tax, and there are two important differences between "adjusted net income" and "net income" as taxed under the appropriate sections of preceding acts. Under prior acts, a corporation might have distributed 50% of its net income and yet retained 50% of its net income to avoid to that extent the imposition of surtax upon its shareholders. The tax on this corporation under the prior acts would have been at the rate of *50% of entire* net income, or *100% of undistributed* income. It was entirely possible under these acts for the amount of the tax to have been several times larger than the amount of the income improperly retained. This situation was corrected by permitting a deduction in computing "adjusted net income" of amounts distributed to shareholders.

The revenue act of 1935 [142] was passed in answer to a tax message from the President to congress dated June 19, 1935, in which he contended that the advantages conferred by the government upon corporations increased in value as the size of the corporations increased, that the advantages gained by the large corporations engaged in interstate business were derived through the federal government chiefly and that the principle of taxation in accordance with ability to pay, as well as in accordance with benefits received, should apply to corporate taxation.[143] The President recommended a graduated rate scale for corporate income instead of a uniform rate. In order to prevent the larger corporations from escaping the tax in the higher brackets by doing business through numerous subsidiaries or affiliates, a tax on dividends received by corporations was advised. The President also urged the desirability of simplifying corporate structure by eliminating superfluous holding companies.

Congress acceded to the proposal for a graduated rate scale on corporate income, but the scale was only slightly graduated, the rates ranging from 12½% on net income less than $2,000 to 15% upon net income in excess of $40,000.[144] In order to prevent evasion of tax in the higher brackets by the formation of numerous subsidiary corporations doing a business which otherwise would be done by the parent corporation, the section of the 1934 act permitting a deduction by a corporation of dividends received from a domestic corporation was amended to reduce the deduction from 100% of the amount of the dividends received to 90%.[145]

[142] Act of Aug. 30, 1935, c. 829, 49 Stat. 1014.

[143] Report of committee on ways and means on the revenue bill of 1935, pp. 1-4.

[144] Sec. 102(a).

[145] Sec. 102(h).

The 1935 act allowed to corporations a deduction for charitable or other contributions made during the year not to exceed 5% of net income.[146] This deduction has been continued in later acts.

The surtax on personal holding companies introduced in the 1934 act was also amended by the 1935 act, the new rates for taxable years beginning after December 31, 1935 being made 20% of the amount of the undistributed adjusted net income not in excess of $2,000, 30% of the amount in excess of $2,000 and not in excess of $100,000, 40% of the amount in excess of $100,000 and not in excess of $500,000, 50% of the amount in excess of $500,000 and not in excess of $1,000,000 and 60% of the amount in excess of $1,000,000.[147] Moreover, a deduction was permitted from "adjusted net income" for distributions made out of earnings and profits during the year, even though an operating deficit existed and was carried over from prior years.[148] Under the definition of dividend existing in the 1934 act,[149] a corporation carrying a deficit could not remove itself from the operation of these provisions by making a distribution.[150]

In furtherance of the suggestion of the President regarding the simplification of corporate structure, and to encourage liquidation of what were considered unnecessary holding companies, a section was included in the 1935 act providing for the non-recognition of gain or loss to a corporation upon the complete liquidation of its subsidiaries.[151] "Complete liquidation" was defined so as to include each one of a series of distributions by a corporation in complete cancellation or redemption of all of its capital stock in accordance with a plan under which the liquidation will be complete within five years from the end of the taxable year during which the first of the series of distributions was made.

For years beginning with the year ending June 30, 1936, the 1935 act increased the capital stock tax rate from $1.00 to $1.40 per $1,000 of the new "adjusted declared value" of the capital stock.[152] For taxable years ending after June 30, 1936, a new excess profits tax was imposed at the rate of 6% of net income in excess of 10% and not in excess of 15% of the adjusted declared value of the capital stock of the corporation, and 12% of net income in excess of 15%.[153]

[146] Sec. 102(c).

[147] Sec. 109(a).

[148] Sec. 109(b).

[149] Sec. 115(a).

[150] Sec. 351(b) (2) (C), act of 1934.

[151] Sec. 110(a).

[152] Sec. 105(a).

[153] Sec. 106(a).

The 1935 act, with the exception of sections not mentioned in this paper, is applicable only to taxable years beginning after December 31, 1935,[154] and before it became effective was superseded by the revenue act of 1936.[155]

In the message which led to the 1936 revenue act, the President pointed out that the evil of evasion of surtaxes through the accumulation of profits in a corporation was an old one and a growing one, and that the treasury had estimated that during the calendar year 1936 over four and one-half billion dollars of corporate income would be withheld from the corporate stockholders.[156] The retention of profits in corporations not only enabled the shareholders of those corporations to escape surtaxes, but also because of this means of evasion gave to incorporated businesses great advantages over those unincorporated, said the president. In order to eliminate this "serious two-fold inequality," the President suggested a tax on undistributed corporate income, including intercorporate dividends, and a repeal of the tax on corporate income as provided by the then existing law and also the repeal of the capital stock and excess-profits taxes.

It will be recalled that in the group of taxes first mentioned in this paper, namely, the civil war taxes, the end for which the President was striving through his recommendations was reached. That end is the taxation to the individual owners of businesses, whether incorporated or not, of their pro-rata share of the profits of the businesses. Although the act of June 30, 1864 was upheld in the case of *Brainard* v. *Hubbard*, and it was decided in that case that congress could tax to shareholders their distributive share of the undivided profits of a corporation, this decision has been disapproved,[157] and it is doubtful if congress could now impose such a tax, that is, unless a new definition is given by the supreme court to the word "incomes" as used in the sixteenth amendment.

It has been pointed out that years later, the 1913 and 1916 revenue acts provided that where a corporation was fraudulently formed or availed of for the purpose of avoiding taxes upon its stockholders, the net income of the corporation should be considered, for purposes of determining the net income of the respective shareholders, as though it has been distributed. The act of 1917 taxed at 10% corporate profits remaining undistributed six months after the end of the taxable year. Furthermore, provision was made in the world war tax acts that the net income of personal service corporations should be considered for purposes of determining the net income of its shareholders as if it had been distributed, whether or not it had been actually so distributed.

[154] Sec. 107.

[155] Act of June 22, 1936, Sec. 1, c. 690, 49 Stat. 1652.

[156] Report of ways and means committee on revenue bill of 1936, p. 1.

[157] Eisner v. Macomber, *supra*.

The revenue act of 1936 as finally adopted by congress was not entirely in accordance with the suggestions of the President. The house bill, it is true; provided for a thoroughgoing undistributed profits tax and the repeal of the then existing corporate income tax and the capital stock and excess-profits taxes. However, the senate insisted upon and obtained important modifications of the house's undistributed profits tax as well as a continuation of a corporate income tax at graduated rates and the capital stock and excess-profits taxes.[158] The tax on undistributed profits as passed provided for a tax upon what under the act is defined as the "undistributed net income" of a corporation at rates graduated in accordance with the percentage of "adjusted net income" which is undistributed.[159] The "adjusted net income" includes all dividends received even though for normal tax purposes a deduction of 85% of the amount of such dividends received from domestic corporations may have been allowed. The "adjusted net income" is the net income minus certain amounts including the normal corporation tax paid and the interest from the obligations of the federal government or of any federal corporations which otherwise are credited against net income for the purpose of computing the normal tax.[160] The "undistributed net income" upon which the tax is imposed at graduated rates is the "adjusted net income" minus certain credits including the credit for dividends paid during the year as supplemented by dividends carried over from the two prior years if the dividends in those years as paid are in excess of the year's "adjusted net income," and including a credit for earnings required to be withheld from the payment of dividends in accordance with the provisions of a written contract executed by the corporation prior to May 1, 1936.[161] The rates were as follows:

> "7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.
>
> 12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.
>
> 17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.
>
> 22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

[158] For discussion, see report of Senate Finance Committee on Revenue Bill of 1936, pp. 4, 5, 6.

[159] Sec. 14(b).

[160] Sec. 14(a) (1).

[161] Sec. 14(a) (2).

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income." [162]

Other changes in the tax on corporations were made by the revenue act of 1936. A greater degree of graduation was made in applying the normal tax to corporations, the new tax progressing from 8% on "normal tax net income," less than $2,000, to 15% on such income in excess of $30,000.[163] The deduction or credit against net income for dividends received from domestic corporations was reduced to 85% of such dividends.[164] Prior to the revenue act of 1935 the deduction had been allowed to the full extent of the dividend, and under that act was reduced to 90% of the dividends.

The tax upon corporations formed or availed of for the purpose of preventing the imposition of surtaxes upon their shareholders was amended in the 1936 act so that the old rate of 25% and 35% of that portion of the net income of such corporation under $100,000 and over $100,000, respectively, should apply only to corporations not subject to the undistributed profits tax.[165] The rate applicable to corporations subject to the tax on undistributed profits was made 15% and 25% on net incomes under and over $100,000, respectively.[166] This section in preceding acts had included a provision that it should not apply if all the shareholders of a corporation elected at the time of filing their returns to include in their gross incomes their entire pro-rata share of the "adjusted net income" of the corporations for such year whether distributed or not.[167] The 1936 act limited the benefit of this particular section to those corporations where all of the shareholders elected to include their entire pro-rata share of the retained net income of the corporation in their own returns and where 90% of the retained net income was so included in the returns of stockholders other than corporations.[168] Consequently corporations whose stock to the extent of 11% or more was owned by other corporations would not be entitled to the benefits of this section providing for avoidance of this surtax by the election on the part of shareholders to pay the tax on their pro-rata shares.

Under the 1936 act the surtax on personal holding companies was continued at lower rates ranging from 8% of the amount of the

162 Sec. 14(b).
163 Sec. 13(b).
164 Sec. 26(b).
165 Sec. 102(a).
166 Sec. 102(a).
167 Sec. 102(d), act of 1934.
168 Sec. 102(d).

undistributed adjusted net income less than $2,000 to 48% of the amount in excess of $1,000,000.[169]

The capital stock and excess-profits taxes were retained with the change that the capital stock tax was reduced from $1.40 to $1.00 per $1,000 of the adjusted declared value of the capital stock.[170] This change was made as an amendment to the 1935 act.

After the passage of the revenue act of 1936, the drive to eliminate the practice of many corporations to retain substantial portions of their income was continued for the purpose of forcing all earnings, whether of incorporated or unincorporated businesses, to be taxed to the real owners both at normal and surtax rates. On June 1, 1937, the President of the United States in a message to congress stated that there were several devices resorted to by taxpayers to permit them to escape what were termed to be their just taxes.[171] Chief attention in the President's speech was given to the use of personal holding companies for such purposes. It was pointed out in the report of the ways and means committee upon the revenue bill of 1937, which was drafted in reply to the President's message, that the surtax on personal holding companies under the 1936 act was still low enough to permit individuals with large incomes to save taxes by the retention of profits.[172] It was noted that special savings were made through the use of multiple personal holding companies.[173] With the intent of striking a more effective blow at such practices, congress passed the revenue act of 1937,[174] which increased greatly the rates applicable to personal holding companies,[175] and extended the definition of a personal holding company under the former act.[176] Not only were rates increased, but the 20% of "adjusted net income" allowed to personal holding companies as "grace", probably on the assumption that a retention of no more than this amount could very well be reasonable, at least in some cases, was eliminated and no such "grace" allowed.[177] In addition to this, no provision was made for a company to be relieved from the payment of the tax by any agreement of its stockholders to report in their returns their pro-rata share of the entire net income of the corporation.

[169] Sec. 351(a).

[170] Sec. 401, 402.

[171] Hearings before the Jt. Committee on Tax Evasion and Avoidance, Part 1, p. 2.

[172] Report, p. 3.

[173] Report, p. 3.

[174] Act of Aug. 26, 1937, c. 815, 50 Stat. 813.

[175] Sec. 351.

[176] Sec. 352.

[177] Sec. 355.

The rates of the surtax on personal holding companies were increased to 65% of the amount of the undistributed adjusted net income not in excess of $2,000 and 75% of the amount in excess of $2,000. No deduction was allowed for net losses incurred in previous years but the possible deduction for charitable or other contributions made within the taxable year, which, for income tax purposes, was limited to 5% of net income,[178] was increased to 15% of the net income of the corporation.[179]

The definition of "personal holding company income" was extended to include amounts received under a contract in accordance with which the corporation is to furnish the personal services of some person, designated by name or description in the contract, or permitted to be chosen by some person other than the corporation, where the person performing the services owns 25% or more of the stock of the corporation.[180] This was passed in order to reach what were referred to as the "incorporated talent" companies, formed for the purpose of permitting an individual who would otherwise receive a high income from the sale of his services to sell his services to a corporation at a low price so that the corporation in turn could sell his services at a higher price to the persons with whom, but for this tax device, the person performing the services would have directly contracted. In this way, only a small income would go to the individual, and the largest part of the income to the personal holding company, and thus high surtaxes upon the individual would be escaped.

Personal holding company income under the new act included also amounts received by the corporation for the use of or right to use property of the corporation, where the one using the property or having the right to use the property owned 25% or more of the stock of the corporation.[181] This was done to prevent such practices as the highly publicized incorporation of yachts, city residences, country estates, etc. It was shown that taxpayers incorporating such property in turn rented the property from the corporation and paid sufficient rent to remove the corporation from the definition in the act. Under the prior law, the payment of rent equivalent to more than 20% of the gross income of the corporation removed it from the definition of a personal holding company. Further effort was made to prevent this practice by a limitation placed upon the amount of expenses and depreciation which could be taken for the purposes of computing personal holding company net income.[182] Before such deductions for the operation and maintenance of prop-

[178] Sec. 23(q), act of 1936.

[179] Sec. 356(a) (2).

[180] Sec. 353(e).

[181] Sec. 353(f).

[182] Sec. 356(b).

erty to the extent that they exceeded the rent received for the property could be taken, it was provided in the act that corporations must show to the satisfaction of the commissioner that the rent was the highest receivable and that the property was held in the course of a business carried on bona fide for profit, and that there was an expectation of profit, or that the property was necessary in the conduct of the business. This was intended, for example, to prevent a personal holding company, owning a yacht and renting it to one of its principal shareholders, from deducting from other income the excess of the expenses of the yacht over the rent.

The prior law made no inclusion in personal holding company income of income received by corporations from estates or trusts. A person could form a personal holding company, create a trust, and provide that the income of the trust be paid to the personal holding company. Under the new act, income from estates and trusts were included.[183] Rents also were included as personal holding company income, unless they constituted 50% or more of the entire gross income.[184] This prevented an individual from establishing a personal holding company and transferring to it sufficient rental property so that slightly more than 20% of the income of the personal holding company would be derived from such rentals.

Other changes were made to strengthen the personal holding company provisions. The definition of stock ownership was extended in order to offset attempts to distribute apparent ownership while retaining the real control and ownership in five or less persons.[185] Also, it was provided that if in any year a corporation falls within the definition of a personal holding company, it shall be considered a personal holding company in every year thereafter if 70% or more of its gross income is "personal holding company income" or until a taxable year during the entire last half of which the stock ownership requirement does not exist, or until there had expired three consecutive years in which less than 70% of the gross income constitutes "personal holding company income." [186]

It was presented to the tax committees of congress that foreign personal holding companies had been increasingly popular as loopholes for tax avoidance. The 1937 act established a method, which will not be discussed in full here, of taxing to the shareholders of a foreign personal holding company their share of the undistributed net income of such foreign corporation.[187]

As the committees of congress charged with the drafting of the revenue act of 1938 met to consider the effects of the then existing

[183] Sec. 353(d).
[184] Sec. 353(g).
[185] Sec. 354.
[186] Sec. 352(a) (1).
[187] Secs. 331-341, Title II.

law, they were faced with strong protest against the operation of the undistributed profits tax under the 1936 act. The country at the time was suffering from a business depression and the demands were that definite steps be taken by congress to alleviate certain provisions of the 1936 act and particularly those establishing the undistributed profits tax. As listed in the report of the ways and means committee on the revenue bill of 1938, "the principal complaints against the surtax on undistributed profits in the form imposed by the revenue act of 1936 may be summarized as follows: (1) The surtax discourages, in many cases, legitimate business expansion, and, therefore, has an adverse effect on employment. (2) It puts a penalty on corporations which find it necessary to use current earnings in the payment of debts. (3) It burdens the small and weak corporations more than the large and financially strong corporations. (4) It is unfair to corporations with impaired capital which under state law cannot legally declare dividends. (5) The relief provisions applying to corporations having contracts not to pay dividends or requiring the use of current earnings for the payment of debts are so restrictive as to provide relief only in rare cases, although many other cases equally meritorious receive no relief." [188]

The demands for relief were heeded by both the house ways and means committee and the senate finance committee. The house committee recommended a flat tax rate of 20% upon corporations with net incomes in excess of $25,000 with a credit against net income of 4% of dividends paid out so that the minimum tax in the event of 100% distribution of profits would be 16%.[189] The senate finance committee recommended the complete abandonment of the principle of the undistributed profits tax and advocated a return to the policy of a single flat rate for corporate taxation with relief provisions for corporations with net incomes less than $25,000.[190]

The bill finally agreed upon in conference between representatives of the two houses of congress followed the house bill in the combination of the income tax with the undistributed profits tax.[191] Under the act as adopted, the maximum rate of corporate income tax is 19% with some reduction in this tax to be based upon the amount of dividends distributed.[192] The maximum reduction is 2½% so that the minimum tax upon corporations under the 1938 income tax law is 16½%. As recommended by both house and senate committees, special relief provisions were made for cor-

[188] Report, p. 3.

[189] Report, pp. 4, 5.

[190] Report, pp. 2, 3.

[191] Conference Report to House, p. 33.

[192] Sec. 13(c).

porations with incomes less than $25,000.[193] and provisions also were adopted in order to provide adjustments for corporations with incomes slightly in excess of $25,000.[194] Other relief provisions include a two-year dividend carry-over,[195] a one-year net operating loss carry-over,[196] and a "consent dividend credit."[197] Further relief provisions were adopted for those corporations which have a deficit in accumulated earnings and profits which is in excess of their net operating loss for the preceding year.[198] Corporations with net incomes of less than $25,000 are not subject to the tax discussed above, but are taxed upon their net income, less interest received from specified federal obligations and less 85% of dividends received from taxable domestic corporations, at rates progressing from 12½% of income less than $5,000 to 16% of such income as is in excess of $20,000.[199] The total tax on a "special class net income" of $25,000 amounts to $3,525.00, or 14.1%.

Among the salutary provisions in the act is the "deficit credit". A corporation with an income in excess of $25,000 is taxed at a rate of 19% with a possible credit for dividends paid of 2½%. This "dividend paid credit" includes the excess of any deficit in accumulated earnings and profits as of the close of the preceding taxable year over the amount of the "net operating loss credit" taken for the preceding year.[200] The "net operating loss credit" referred to is included with the "deficit credit" in the "dividend paid credit" which includes also reasonable amounts used or irrevocably set aside to pay or retire indebtedness *of any kind,* provided that the indebtedness was in existence before January 1, 1938 and was evidenced by a bond, note, debenture, certificate of indebtedness, mortgage or deed of trust issued by the corporation and in existence at that date or by a bill of exchange accepted by the corporation prior to and in existence before that date.[201]

The surtax on corporations improperly accumulating a surplus was continued in the 1938 act very much in the same form as it is found in the 1936 act, with the principal difference being that, whereas in the 1936 act and prior acts the unreasonable accumulation of profits established merely a presumption that the corporation was being availed of for the purpose of evading the surtaxes upon shareholders, such an accumulation under the 1938 act is to be

[193] Sec. 14.
[194] Sec. 13(d).
[195] Sec. 27(c).
[196] Sec. 27(b) (2).
[197] Sec. 27(b) (1).
[198] Sec. 27(a) (3).
[199] Sec. 14.
[200] Sec. 27(a) (3).
[201] Sec. 27(a) (4).

considered as determinative of the purpose to avoid such surtaxes unless the corporation is able to prove by the clear preponderance of evidence that this was not the purpose of the accumulation.[202]

Little change was made in the tax on personal holding companies as introduced by the 1937 act.[203] Personal finance companies were excluded from the definition of a "personal holding company" under the act,[204] and corporations making consolidated returns were brought within the definition if the stock ownership of the parent corporation and the income of the affiliate group fall within the personal holding company classification.[205]

The capital stock and excess-profits taxes were retained [206] with the single significant change that the corporation could declare anew the value of its capital stock for the year ended June 30, 1938, and, what is important, for each third year thereafter.[207]

Certain new provisions were included in the 1938 act which were intended to stimulate the simplification of corporate structure. To encourage the liquidation of unnecessary corporations, it was provided that an individual shareholder meeting the requirements of the act may elect to have the gain on liquidation treated as a dividend to the extent of his share of the profits and earnings accumulated since February 28, 1913, and the remainder of the gain treated as a long-term or short-term capital gain, as the case may be, and limited to the amount by which his share of the assets consisting of money, or of stock or securities acquired by the corporation after April 9, 1938, exceeds the amount treated as a dividend.[208] The gain of a corporate shareholder is limited to the amount of money, or stocks or securities acquired after April 9, 1938 received by it, or to its share of profits and earnings accumulated since February 28, 1913, whichever is greater.[209] Under these provisions a qualifying individual or corporate shareholder may receive assets upon distribution free of any tax upon gain representing appreciation in the value of these assets in the hands of the corporation, except to the extent that the amount of money, or stocks or securities acquired by the corporation since April 9, 1938, exceeds the distributive share of profits and earnings accumulated since February 28, 1913. It remains to be seen how successful these provisions will be in encouraging the liquidation of unnecessary corporations. Their effectiveness will soon be ascertainable, as it is provided in the act that distributions within the meaning of the act for this purpose must be made within the month of December, 1938.[210] It may also be noted here that additional incentive to corporate liquidation by

[202] Sec. 102(c).
[203] Secs. 401-411.
[204] Sec. 402(b).
[205] Sec. 402(c).
[206] Secs. 601, 602.
[207] Sec. 601(f) (1).
[208] Sec. 112(b) (7) (E).
[209] Sec. 112(b) (7) (F).
[210] Sec. 112(b) 7) (A).

individual stockholders in higher surtax brackets may be found in the new capital gains provisions of the 1938 act.[211]

The corporate income tax provisions of the 1938 act are not applicable to any taxable year beginning after December 31, 1939.[212]

There is outlined below a summary of corporate tax rates since 1909, with the specific exemption for each year, if any, and, for comparison, normal tax rates on individuals since 1913. This summary shows also whether or not deductions or credits were given to corporations and individuals for dividends received.

SUMMARY OF CORPORATE AND INDIVIDUAL TAX RATES, ETC., SINCE 1909

Year	Tax Acts	Corporation Tax	Normal Tax on Individuals	Deduction of Dividends for Corporate and Normal Taxes	Specific Corporate Exemption
1909–1912	1909	1%	none	Corporations	$5,000
1913–1915	1913	1%	1%	Individuals only	none
1916	1916	2%	2%	same	same
1917	1917	2% 4%	2% 2%	same both	same same
1918	1918	12%	6% on $4,000 12% on balance	same	$2,000
1919–1920	same	10%	4% on $4,000 8% on balance	same	same
1921	1921	10%	same	same	$2,000 where net income less than $25,000
1922–1923	same	12½%	same	same	same
1924	1924	12½%	2% on $4,000 4% on next $4,000 6% on balance	same	same
1925	1926	13%	1½% on $4,000 3% on next $4,000 5% on balance	same	same
1926–1927	same	13½%	same	same	same
1928, 1930–1931 .	1928	12%	same	same	$3,000 where net income less than $25,000
1929	1928—Jt. Res. 1929	11%	½% on $4,000 2% on next $4,000 4% on balance	same	same
1932–1933	1932	13¾%	4% on $4,000 8% on balance	same	none
1934	1934	13¾%	4%	same	same
1935	1934–1935	12½ to 15%	4%	100% to individuals. 90% to Corps.	same
1936–1937	1936	8 to 15%	4%	None to individuals. 85% to Corps.	same
1938	1938	12½ to 19%	4%	None to individuals. 85% to Corps.	same

[211] Sec. 117.

[212] Sec. 15.

CHAIRMAN EDMONDS: This is one of the epoch-making reports before the conference. So long as the copies are available, please help yourselves.

SECRETARY W. G. QUERY: Before any of you leave the hall I want to make an announcement which is important. The session for this evening, if you will note on your program, is a banquet session in honor of the old-timers.

The presidential address also will be delivered and the annual meeting of the National Tax Association is scheduled. There is an impression prevalent that only the old-timers are supposed to attend the banquet tonight. That is a mistake. Every delegate, everyone in attendance upon this conference, is expected to be at this banquet if he wants to honor the memory of the old-timers who have passed away, as well as those who are present at this conference. It was necessary for the committee arranging the banquet in honor of the old-timers to draw a line somewhere as to what constituted an old-timer. The committee probably has no particular reason as to why it selected the group, but we have selected all those who have been members of the association for fifteen years or longer. We want that group to sit at special tables.

CHAIRMAN EDMONDS: We return to the discussion of Dr. Haig's report. Three members of the committee, Mr. Seidman, Dr. Kendrick, and Dr. Colm, have advised me that they would like to take part in this discussion under the seven-minute rule. We will therefore have the discussion from the members of the committee first.

Mr. Seidman, of New York!

FRANK E. SEIDMAN (New York): Ladies and Gentlemen: The present tax situation in this country puts one in mind of the preacher who announced that the subject of his sermon would be the *status quo*, but, he added, "In case yo-all doesn't know what that means, I will say that it is the Latin for the terrible mess we is all in."

In grappling with the ramifications of the corporate tax problem the committee of course reviewed some of the pros and cons of the undistributed profits tax. While as the preliminary report indicates no conclusion has as yet been reached in the matter, I would personally like to express a few thoughts on this important subject. Before doing so, however, may I recall for you a philosopher's conclusion that, "few persons really think." Instead they devote their time to a rephrasing of their prejudices. I may just as well confess my prejudice and shock you right at the start. I am in favor of the basic principles of the undistributed profits tax. I know that I have but little company on my side in this audience, and for that matter in the country in general. However, unpopular as it may be

at present, I feel that the principle of this tax is bottomed on a solid foundation and that eventually it will come into its own both in popularity and in scientific acceptance.

It is generally assumed that this tax is entirely a New Deal concoction. Shocking as it may seem to some of you, it is not a completely new rabbit pulled out of the New Deal hat. England has had a taxing law for many years containing this principle. The second income tax ever imposed in this country, which was in 1864, provided for a tax on retained profits. Since then, undistributed profits tax measures were proposed in congress a number of times, and in 1924, during President Coolidge's administration, the senate actually passed such a law, only to be killed in conference.

In his message to congress in March 1936, the president stated that undistributed profits tax is one "which would accomplish an important tax reform, remove two major inequalities and stop leaks in present surtaxes."

The major inequalities referred to by the president, resulted from the differences in taxes which were levied upon business income depending upon the form of organization under which the enterprise carried on. Under the old law, an income tax of 13¾ per cent was levied upon the income of corporations, whereas individual tax rates went up to 79 per cent. As a result, disparity of taxes as high as 500 per cent was sometimes involved, depending entirely upon whether a business was carried on as a corporation, partnership or proprietorship. Now, obviously, there is something wrong with a taxing system that permits any such spread because of the mere difference in the form of organization.

It will be remembered that in outlining his suggestions the president proposed that corporations as such be entirely freed from all taxes, but that they be considered as "business conduits" so that the stockholders may be taxed on their proportionate share of corporate profits. On the other hand, corporations failing in their "conduit" obligations were to pay taxes at such rates as to yield revenue approximately commensurate with the amount of taxes that would be derived from the shareholders had the income been distributed.

The actual law that was enacted in 1936 was a far cry from this program. Not only did it include a high corporate undistributed profits tax, but high corporate normal taxes, capital stock taxes and excess profits taxes, all heaped on top of it. No wonder then that howls went up to high heaven against this monstrosity and that congress voted it out of existence at the first opportunity. However, when the 1938 law was adopted, it did not materially improve matters insofar as scientific taxation is concerned. It continued the multiplicity of corporate taxes. It did reduce the undistributed profits tax so that it was a mere shadow of its former self, and in the form in which it was adopted really has no rhyme or reason.

Time will not permit me to discuss the pros and cons of the undistributed profits tax or the incongruities that made the 1936 experiment a dismal failure. I do, however, want to add a few items to those contained in the committee's report which, to my mind, made the 1936 undistributed profits tax indefensible and impossible:

(1) One of the basic undistributed profits tax principles that the 1936 act violated is that it failed to allow credit in some form for distributions of income that was previously subjected to undistributed profits taxes. This accentuated the whole problem of corporate versus individual taxes and resulted in hardships and distortions all around. If the undistributed profits tax is to be adopted as a fundamental taxing policy, it must be premised on the "conduit" theory, and as such would require some follow-through in terms of credit if distributions are made within a reasonable time after they are earned.

(2) The tax was imposed on fictitious rather than real income. This largely because capital losses were not taken into consideration. Actual rather than fictitious profits should be the measure of dividend-paying ability.

(3) Profits on a consolidated basis is the only sound measure of dividend-paying ability where a company has subsidiaries involving in effect branches of its business. In prohibiting consolidated returns the act failed to meet the primary tenets of equity and common sense.

(4) Under the 1936 act, stockholders were not permitted to report their pro-rata share of earnings in their individual income tax returns. This meant that close corporations had to go through meaningless and unnecessary circumlocutions and much red tape in effecting distributions, etc.

In the light of the defects and imperfections in the 1936 mechanism it is my contention that the principle of the undistributed profits tax has never really been tried. I am confident that if some of the corrective features of the 1938 act had been originally part of the 1936 act and generally rather than restrictively applied, and if on top of that the distortions I have mentioned, particularly that of the tax credit to the stockholders, had been corrected, the story would have been a completely different one.

In any event, may I urge that pending the completion of the study by the corporations committee now under way, this conference defer taking any conclusive action upon this important matter.

Just a word in conclusion. Those of you who have seen the Broadway stage production "Pins and Needles" will remember a song hit in it called "Sing Me a Song of Social Significance." Some of the tax proposals, as this song suggests, have distinct social significance. We have heard much in the last few days to the effect that governmental taxes should be for revenue only and should have

nothing to do with the social problems of the country. Consciously or not that philosophy has long been abandoned. Ever since the adoption of the protective tariff over a century ago and the passage of the progressive income tax in 1913 social factors have played important parts in governmental taxing plans. Recent years have unquestionably witnessed an acceleration of this trend and there is every indication that the years ahead will witness more of it. May those who consider this trend undesirable take solace in the fact that it may be the lesser of two evils if the use of taxation for social ends will aid in perpetuating our profit system and preserving our liberties it may in the long run be found not to be a prohibitive price.

CHAIRMAN EDMONDS: The discussion will be continued by Dr. M. Slade Kendrick, of Cornell University, also a member of the committee.

Dr. Kendrick!

M. SLADE KENDRICK (New York): Mr. Chairman, we have already sat here for some time, and we have heard the long report. I myself should personally very much rather hear from some members who didn't have the advantage of working on the committee, as I did. So if I may be excused from that, I shall yield the floor to some other gentleman.

CHAIRMAN EDMONDS: Then the last of the committee members that I will call on will be Dr. Colm, whom we heard with such pleasure this morning.

GERHARD COLM (New York): Mr. Chairman, Gentlemen: I really can't understand how many people believe that nobody profited from the Undistributed Profits Tax Act of 1936, as I read it once in the paper. I think at least one group of people with a great vested interest profited from the undistributed profits tax in 1936—and this was a student of taxation writing. I think especially the members of this committee all must be grateful for this act of 1936, because I can't remember any scientific discussion transacted in such a spirit of mutual understanding and in such a spirit of cooperation.

The committee asked me especially to look into foreign tax legislation. I may in two sentences summarize it that in quite a number of countries the problem has been approached in one or the other way. Partly, more or less, I would almost say that without a knowledge of these countries in question.

For instance, Great Britain has an undistributed profits tax which probably few people over there will realize, because no income tax is imposed upon corporations and the individual stockholders are permitted to deduct the dividends received from their income tax

declaration so that what remains is a tax on undistributed profits taxed by the corporation.

In Belgium the tax deduction is done by the corporation itself. Here I may mention that one member of this conference who is here in the room showed me a telegram from an economist in Belgium who said that there does not exist any such thing as an undistributed profits tax in Belgium. Now the tax is on the statute books under such a name since 1919—maybe 1921; I am at the moment not quite sure—but this economist didn't know that it existed, which indicates that from the standpoint of the public reaction very much depends upon the way such a tax is introduced and how it is phrased. In France we have an undistributed profits tax; in Norway we have an undistributed profits tax.

I may mention that the Netherlands has just the opposite of an undistributed profits tax — it has a special tax on the distributed share of profits.

Germany has, although with a reduced rate recently, a special tax on the distribution of dividends in case of a loss. If these declarations surmount a certain minimum percentage, a special tax must be paid, although the corporation has no profit.

To my mind this indicates how everywhere this problem has been attacked.

I found it especially significant that this report submitted by our chairman stressed that somehow the problem of equal burden imposed on the undistributed and non-distributed share of profits must be attacked. I would say that we should stop calling this tax a penalty tax, because what it really tries to be is a diminution of the discrimination imposed on the undistributed share of profits. On the other hand, we have many discriminations and many arguments can be advanced in favor of keeping a certain tax privilege for the undistributed share of profits, if this is believed to be necessary, in order to offset other disadvantages.

To be more specific, you have the case of small corporations, the whole problem of small and middle-sized industry in general. Our whose financial set-up in our economic system acts to the advantage of those corporations which have an easy access to the capital market and to those corporations which can issue bonds and so forth which are eligible for institutional investments.

So it could be said—and I think this is the right way of closing the problem—is it justified and necessary to grant certain tax advantages—a tax subsidy, if you wish—to small, middle-sized industries, in order to offset the financial disadvantages which they have under our organization?

Then, of course, this problem comes up. Are there means of offsetting this disadvantage through special financial institutions, and so on? But I think this already indicates what a problem of large amplifications and ramifications we have before us; and I at

least shall be very grateful if we should have opportunity to devote some more time to these problems, which actually surpass tax and fiscal problems, and go to the very core of our economic problems which we state in general.

CHAIRMAN EDMONDS: The subject is now open for general discussion, will you allow me to suggest, under the five-minute rule, because we have still one paper this afternoon.

CLARENCE L. TURNER (Pennsylvania): I think, in view of the fact that I have made a suggestion to the committee that a resolution be offered to this conference for consideration, that the conference go on record against the undistributed profits tax, it is probably well, in answer to Mr. Seidman, that I make a few remarks.

I think one of the points made by the proponents in support of the undistributed profits tax which is subject to criticism is the using as a basis for analogy what has been done in certain other countries. In my opinion, this is America, and in America business is done differently than in those other countries. We have large corporations, very large corporations, middle-sized corporations, and small corporations. The undistributed profits tax on a graduated scale taxes all the profits of corporations, irrespective of their size, without regard to the capital invested.

Such a tax appears to be economically unsound and unwise, and accomplishes just the opposite to what the proponents of the undistributed profits tax aim it to do—that is to break up monopolies—because certainly the larger corporations can distribute a larger percentage of their earnings and survive than can the smaller corporations.

For example: a seventy per cent distribution by a large corporation would leave thirty per cent for plant expansion and other purposes. Thirty per cent of the earnings of a large corporation is a considerable sum of money. On the other hand, a small corporation planning plant expansion would not be able to make a similar distribution, because thirty per cent of its earnings would be so small that it would be inconsequential in comparison with the amount it might require for plant expansion and other purposes.

I agree that there have been abuses in certain quarters by the accumulation of surplus instead of its being distributed to the stockholders, and thus the stockholders in those corporations may have gotten an advantage over those of corporations that have distributed. But there is in the revenue act a section, namely, 102, that is supposed to offset that advantage, and, as we have learned from the National Grocery decision, and some of the other decisions, it is beginning to work.

I believe that profits have to be taxed at the source in order to be economically sound. Any tax system must be based on such a

principle. I am in agreement with the suggestion that was made some years ago by Dr. Thomas S. Adams, to the effect that the corporation and the individual taxes on income should be approximated so that there would be no advantage in operating business in corporate form over that in unincorporated form.

But in considering such a basis there must be taken into consideration the size of the corporation and its investment. The old excess profits tax, even with the apparent difficulties that were had in determining the amount of invested capital, certainly was much better and much more simple than the undistributed profits tax, and really accomplished the purpose and did it fairly. The only thing which the law imposing that tax did not do which should have been done was to have made all distributions by the corporation after it was so taxed, tax free to the shareholders. Under such a principle the earnings are taxed at their source and there is eliminated such technicalities relative to the source of dividends, that is whether they are from earnings since March 1, 1913 or not, or whether they are from non-recognized gains for tax purposes or from taxable income. And then the stockholders who own the stock at the time the profits are earned are indirectly paying the tax bill once and for all time.

Any form of tax such as the undistributed profits tax as was contained in the 1936 act and is contained in the 1938 act means that the stockholders who own the stock of the corporation at the time the tax was levied must indirectly bear the tax paid by the corporation, and then pay a further tax when the amount retained is subsequently distributed unless they dispose of their stock. The stockholder who indirectly pays the bill in the form of taxes paid by the corporation loses entirely the benefit that seemingly has been obtained by the corporation paying the tax.

So I think the principle of taxes being levied at the source, that is, where the income is earned, making the corporation rates commensurate with the individual rates and all corporate distributions tax free to shareholders, would be more simple and give the answer that the proponents of the undistributed profits tax are undertaking to obtain.

Noel Sargent (New York): It seemed to me that Mr. Seidman certainly presented some very effective points as to inequities which were contained in the undistributed earnings tax as it was applied. In his very interesting historical survey, however, he neglected one experience which we had in this country with the undistributed earnings tax, as contained in the war revenue act, which, however, did contain a very broad exemption for sums which were retained in the business for use in the business, which, of course, was not contained in the tax of 1936. It seems to me that Mr. Turner has expressed some of the basic objections to the tax. In the first place, of course, objection might be considered as to whether it is desir-

able to have tax policies designed to control business. I am not going to enlarge upon that point. Much could be said upon it both pro and con, of course.

I think, however, that Dr. Colm and others stressed one of the other main points which is involved. Mr. Turner said that a larger percentage of earnings can be retained by large companies—experience shows that not only can it be retained, but that it is retained—than by the small companies. The obvious result is that the effect of an undistributed earnings tax is to handicap the young and small company in its attempt to grow, as compared with the larger company.

Not only does this affect the matter of growth, but it also affects the matter of security for these companies, and in an age when we are speaking of economic or social security it might be considered worth while to give some thought as to whether we desire to promote the security of business concerns or to promote increasing insecurity among business concerns.

Carter Glass a few years ago, in connection with a somewhat similar tax proposal, said that one of its effects was a tendency to promote old ventures in their monopolies. I think that is certainly an aspect which should be considered in conjunction with a tax of this sort. Obviously, it is the opposite, as was pointed out, to some effects in the report by Mr. Haig of the proposal in 1935, because whereas the presidential proposals in 1935 as embraced in the revenue act of that year, were designed to penalize the large companies, the inference that is being placed upon size as being objectionable in itself, the net effect of the 1936 act was exactly the opposite—to reward size and penalize littleness.

Dr. Colm has apparently recognized this result to some extent, because he stated, if I understood him correctly, that we might have some differentiation which would favor the small and medium-sized corporations. It would seem to me that we would at least from an economic standpoint, as well as from a purely tax standpoint, need to give extremely careful consideration to the standpoint of whether we would like to have any governmental agency or congress attempting to say at what point it is desirable to protect and give special favors to corporations of particular sizes without considering in any way the intrinsic merits of those corporations as to whether they were qualified to stay in business or to succeed or were performing a useful economic function and to determine that the sole basis of their desirable continuance and tax favoritism designed to promote it should be merely on the basis of their size.

I know from talking to a large number of corporation executives within the past year that one of the effects of the 1936 revenue act was to force unwise distribution of dividends, and that this has been a serious handicap to them in the recession which we have recently experienced.

Dr. Colm, of course, referred to the situation in Holland and in Norway, that in Holland being, as he said, exactly the opposite of the tax which we had here. He mentioned the situation in Norway, and I presume he, as well as you, are aware that in Norway, while they still retain the tax on the statute books, there has been a gradual tendency, over a period of years, for the various governments in power, including the support received from the labor unions in that country, to reduce the burden of tax to relieve the handicap it has been placing on industry; although, as I say, they still do retain the tax in a small amount on the statute books.

I think Professor Seligman said a few years ago—and I will conclude with his remark—supporting the situation in Holland, that we might well consider from an economic standpoint placing a special tax upon those who distribute these dividends and rewarding those who do not, from an economic standpoint, or promoting the source of revenue from which all taxes must ultimately come.

CHAIRMAN EDMONDS: Is there any further discussion?

ALFRED G. BUEHLER (Vermont): I don't want to join in the controversy over the undistributed profits tax, but this very able report of the committee headed by Dr. Haig should, I think, be required reading for all of us. In the report there is a sentence that deals with a very important current social and fiscal philosophy in many of our problems—"Granting that when a given economic program has been incorporated into established public policy, it is desirable that tax policy be brought into harmony with it. . . ."

This would seem to imply that under certain cases at least the committee might agree that regulatory or social taxation is desirable. But the committee very wisely refused to split itself open by any controversy over the advisability of particular measures.

It occurred to me that there might be three principles which perhaps could be suggested for the testing of a regulatory tax. It might help us to outlaw many of these regulatory proposals of the panacea type that come from those who are unfamiliar with the effects of taxation and who have some particular hobby or panacea which they would like to see executed and have a brainstorm and hit upon some tax to carry out that project.

The first principle I would suggest would be that the end in view must be clearly socially desirable; that the tax must clearly promote the general welfare. I realize that I am something of a mystic to suggest general welfare, and, perhaps, the social good; but at least we know that certain tax proposals are clearly adopted for the benefit of a particular selfish group. For example, take an oleomargarine tax which is so heavy that it is intended to force the consumer to buy butter instead of oleomargarine to the advantage of the farmer. Take a chain store tax, a discriminatory tax, which

is clearly intended to put the damper on the chain store or put it out of business, for the benefit of the independent merchant. That, to me, would be selfish class legislation, not in harmony with the general welfare of the consuming public.

The second principle would be that this proposed regulatory tax should promote this clearly desirable social objective more effectively than any other available measure. That would eliminate the possibility that the revenue aspects of taxation would be disregarded and completely subordinated to the regulatory aspects, where they should not be so subordinated.

The third principle would be that the social gains and advantages from regulatory taxation would be greater than the losses in revenue and the disadvantages of the regulatory taxation.

I don't know how those principles will appeal to you. I have formulated them tentatively in my own mind, and I realize, of course, that it will be controversial—whether an objective is socially desirable. The stabilization of business by an undistributed profits tax would suggest that, so far as No. 1 is concerned, a stabilization of business is desirable. Then the other questions remain: is the undistributed profits tax more effective than other measures in stabilizing economic conditions? And, thirdly, will the losses from revenue and the disadvantages, social and otherwise, of the undistributed profits tax be greater than the possible gains?

CHAIRMAN EDMONDS: Dr. Haig, would you like to say anything in connection with this report?

MR. HAIG: I have no voice left after the long session that I have already had. I have nothing to add at all.

CHAIRMAN EDMONDS: Then, if there is no objection, shall we pass to the next subject?

WILLIAM A. SUTHERLAND (Georgia): If nobody else is to say anything, I would like to have the privilege of talking for about one or two minutes. I hope Mr. Turner hasn't gone, because I want to say something that I hate to say behind his back.

PRESIDENT LELAND: You will have to do it anyway, because he has left town.

MR. SUTHERLAND: Will you report to him that I wanted him to be here?

I think Mr. Turner's statement about the undistributed profits tax illustrates as well as anything could the lack of really deep analysis that underlies all the discussion that we have heard on this very important subject during these last eighteen months or two years. Unquestionably there were great defects in the undistributed profits tax as enacted quickly into the 1936 act. I don't think anyone could

study the undistributed profits tax portion of that act without realizing that it typifies the worst sort of tax legislation imaginable. It was passed without any proper consideration, without any proper hearings. It introduced a great new principle into our tax law, and one which should have been fully discussed and fully analyzed before it was enacted, and the result was just what you would expect from that sort of legislation.

On the other hand, I don't think anything could be further from the truth, and I don't think anything can more delay the enactment of a proper tax system in this country, than to take some ill-drawn, ill-considered act, such as that, and, because of the defects which that act contains, to condemn a principle with which I believe Mr. Turner, from this stand, expressed his complete agreement, when he was standing here criticizing the undistributed profits tax. He said, if you will recall—and I don't think there would be much need of going any further in his discussion than to repeat his own words: "What I want to see is a corporation tax at the source which will place corporation income on an equality with individual income." If that isn't the substance of Mr. Oliphant's message to congress on the 1936 act, then I can't read the English language. He didn't tell them how they could enact such a thing. The administrative difficulties in connection with it are tremendous. He didn't tell them how they could put his principle into an act, and when they came to enact it into law, or attempted to enact his principle into law, they saw they were going to lose a lot of revenue, and they put on top of the tax he had recommended a whole lot of other corporation taxes which haven't a thing in the world to do with undistributed profits taxes or the principle underlying them.

But what Mr. Oliphant asked congress to do in his message was just exactly what Mr. Turner stood here and told you he was in favor of doing, at the same time he told you he was unalterably opposed to any undistributed profits tax.

I think that is typical of all the discussion which has gone on during the past two years about this very important subject, and I hope that after Dr. Haig's committee, of which I have had the good fortune to be a member, completes its work at the end of this year, we shall all have at least placed the issues before the country, so that they can be discussed on an intelligent basis and without any prejudice.

Chairman Edmonds: Are you passing to your next subject now? If there is no one further who desires to discuss Dr. Haig's report, we will pass on to the last number on the program, "Discussion of Report of Committee on Federal Taxation of the American Bar Association," and that will be presented by Mr. Sutherland of Atlanta.

Mr. Sutherland: Mr. Chairman, Gentlemen: I have had the privilege for the past three or four years of being a member of the committee on Federal Taxation of the American Bar Association. I expect a good many of you in this room do not know what the real purpose of that committee is. I think it is very important to take just a minute to tell you what that committee attempts to do, because I believe there is no other clearing-house in the country for exactly the sort of work that that committee is now attempting to do. I believe that, with the start we have gotten under the very excellent chairmanship of Mr. Robert N. Miller during the past two years—and his position is being taken over this next year by Mr. George Morris, who has been chairman of the house of delegates of the American Bar Association—we can really look to make that committee operate with some real influence in this very important field which no other group is really seeking to cover.

We have taken the position on that committee that we should not attempt to deal primarily or to any appreciable extent at all with substantive questions of taxation: the questions of who in the country should bear the taxes, what the rates should be, whether an undistributed profits tax is sound, whether, if you are to have an undistributed profits tax, there should be some other form of corporate taxation? All those questions we consider entirely without our field. That work is being done by this association, by the chambers of commerce, and by other groups in this country, and our committee leaves that alone as completely as it can.

What we do feel that the lawyers are qualified to deal with is the matter of the drafting of acts to incorporate whatever ideas they are expected to incorporate, and, more especically, the interpretation and the administration of those acts after they are passed. It is the primary purpose of our committee to see that our acts are as well drafted as they can be, and to see that the administration of the acts, both in the treasury department and in the tribunals which have the right to review the treasury department, are as effectively handled and handled with as little friction and with as much fairness as is possible.

Unfortunately, I think in the past the committee has devoted itself too much to specific problems and to specific difficulties which have arisen in administration or in the construction of previous acts. It will always be necessary for the committee to do some of that work, and I want to tell you two or three of the recommendations in the last report of the committee which go to these specific questions, just to give you an idea of the sort of thing with which the committee is dealing.

In the first place, the committee got authority from the bar association at the last meeting to study and report on ways of settling the question of domicile of a decedent when two states are attempt-

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ing to tax the one person as a resident of both states. That is a matter about which there are great procedural difficulties, and one with which, of course, lawyers are particularly qualified to deal.

Then you come to a question like the decision of the supreme court in the case that held that the assumption of indebtedness in corporate reorganization constituted the return of other property or money so that it was taxable. As lawyers, we thought we could see clearly that, whether or not the reorganization provisions of the act were wise—because that is a question with which an association like this would deal—certainly that decision was out of keeping with the whole spirit of those provisions, and we recommended amendments to the act which would eliminate that decision, in effect, from the books.

Then you come to the question like section 820 of the revenue act of 1938, which attempted to eliminate, in effect, the statute of limitations in a number of situations where the government or the taxpayer is taking a position in one year contrary to a position taken in another year, which is now barred by the statute of limitations.

Our committee recommended most strongly against that provision in its present form, at this last session of the bar association. There was not any question of whether the aim which congress was attempting to accomplish in this section was good. It was just a terribly poorly-drawn section which resulted in all sorts of inequities and injustices that could not have been contemplated and certainly never would have crept into the act had any due consideration been given to it and had time been given for public hearings before the act was passed.

As a matter of fact, we did rush in there at the last minute, got in touch with three or four senators, and managed to get some of the worst provisions of the section eliminated before the act was passed; but still, after that was done, it was about as bad as you can imagine. That is all covered fully in the report.

I may say that there are copies of the advance program of the last bar association meeting on the table outside, and that contains, at page 89 and following, the whole report of this committee for the last year.

I just want to take about five or ten minutes to tell you a new note that was struck in this last report by Mr. Miller, that I think will probably go down as one of the finest pieces of work that has been done to aid in the proper administration of the tax laws during the last fifteen or twenty years. Mr. Miller decided that he would give up the idea of attempting to go into a great many specific suggestions as to small defects here and there in the acts, and that he would try to lay down in some form where it would be available to all who wanted to study it what we consider the fundamental principles that should underlie the administration of the tax laws.

He has one fundamental theory, which is — and I think anyone who considers it and considers this country in comparison with some of the foreign countries will know it is absolutely sound—that the government of the United States has an invaluable asset in the good will of its taxpayers. The people in this country generally don't mind paying their fair part of the tax, however much they kick about it. They make a return which shows pretty accurately what their income is, and they pay the tax on that income, and the government doesn't have to go digging around to get it.

We have incorporated the figures in this report, and it appears that out of the income tax collections during the past fifteen or twenty years, there have been about 85 per cent of the taxes paid on the original return. In other words, with all the difficulties of construction of the act and all of that, only about 15 per cent of the taxes collected have been collected on additional assessments.

We feel that that is a remarkable record, and is a great tribute to the taxpayers of this country, and that the government would be very foolish, not only from the standpoint of fairness and decency, but from its own selfish standpoint, not to recognize and preserve that asset which it has built up.

We think that everything possible should be done to do that. There are great temptations that we have seen given way to a few times in the last few years, that tempt us away from that course. You find people here and there evading or avoiding taxes by means that don't seem fair, and it is very easy to get very much excited about that and to do things which will destroy a whole tax system and destroy the good will of the millions of taxpayers who have been paying their taxes voluntarily and willingly, and when you get through you probably haven't got nearly the money you thought you would get when you started out. Certainly, you can't hope to get enough to justify destroying the good will of the vast majority of the taxpayers.

Mr. Miller has a great capacity for homely illustrations, and he has compared the government to a man who is running a hen farm. He goes into his hen-house every morning and finds that about 85 per cent of the chickens have laid eggs right there in the box. Those eggs are all clean; you pick them up, put them in the basket, and take them in. Then he goes down in the field and finds a bunch of eggs down there one day that he hadn't been able to find, and he gets all excited about the fact that some of the hens have gone down in the field and laid these eggs. So he just starts bothering the chickens until finally none of them come in the hen-house and lay the eggs; he is going in the field looking for them all the time, and doesn't get half the eggs he used to get in the house.

It is pretty easy to get in that position, and it is something I don't think any of us can be too careful to try to keep the government from doing.

There are some suggestions that have been made in this report as to some things, which should not be done and some things which should be done, and I would like to discuss them just very briefly for a minute. I think there is general agreement upon them. They just haven't been put down together before, and we don't have any idea that we are going to accomplish these things in the next year or the next two years. But at least we hope this can be a beginning, and that all bodies in this country who are interested in the promotion of a sound tax system can take these things up and approve them, and that gradually we may get them worked into our system and may help keep there the good things that we already have. In the first place, in the interpretation and in the adminis tration of these tax laws—and this is opposed to the drafting of the acts; that is a political question, matters of policy that are too broad to trust to administrative officials—we do feel that if we can build up a civil service such as they have in Great Britain and have it go right up to the top of the department, so far as the administration and construction of the laws is concerned, and can have those administrative officials' decisions as to the law final until you go to the court, and not have them subject to review, as they have been, by politically-appointed heads, which change with the administration, we will have made a great step forward toward a consistent and sound interpretation of our laws; the business community will benefit greatly from it, and the government will benefit greatly from it in the attitude of increased respect and good will which the taxpayers generally will have toward the government.

We also think that we should be most careful to avoid some of the very complicated sorts of provisions which have crept into the tax laws, especially in recent years. We think that to have a law that you can't understand increases the temptation to feel that maybe after all nobody can understand it and you can do what you want. Besides that, it creates an attitude of hostility on the part of the taxpayers toward the law, which we think is very unsound, and generally unnecessary. Certainly we don't think it is necessary to have as many provisions of that sort as we have had.

In that same connection it should be pointed out that the great frequency of major changes in the tax laws has had a very bad effect. Taxpayers do not have time to get themselves adjusted to the system under which they must operate. Major changes should be much more slowly made. We should go ahead studying the possible improvements which may be made, but the laws should not actually be changed until a system is worked out which can be expected to have some degree of permanence. Less harm will come from operating for a considerable time under a law which may not be quite as good as another which could be devised—if the price of improvements is constant change and uncertainty. In other words,

we believe that the gain in certainty and ease of administration which come from a fairly constant law greatly outweighs the benefits resulting from improvements in the law—if the improvements can be effected only by constant major changes in the acts.

There are some complexities of length and some of uncertainty and confusion. The complexities of length are bad enough, but those of confusion are certainly very much worse, and every effort should be made to avoid them.

We think also that the treasury department should take more leadership than it has taken in the interpretation of the tax laws; that they shouldn't be afraid to say what the law means, and take a consistent course, even though it might look like, at certain times, they are going to lose a certain amount of revenue by it. It would result in much less frequent reversals by the courts, and, I believe, would give us a much sounder interpretation of our laws, because no court has before it all the different facts and circumstances with reference to a large number of taxpayers, which the treasury department does have before it at all times.

We think that it should take every advantage of that position to adopt a sound and statesmanlike interpretation of the laws, which we think it would then be in a position to enforce on the courts, very much as I understand in Canada the department there has been able to get the courts to approve practically every interpretation which it has made of its law.

We think also that a great deal of ill-will would be avoided, a great deal of good will saved, if fair compromises, particularly in small cases, could be worked out on disputed questions of law and fact. There is nothing inconsistent between a compromise in a small case, whether it be a doubtful question of law or fact, with a contest of that same question of law or fact by some other taxpayer. If the case is settled on its then fair value, we think that the government gains greatly, certainly the taxpayer gains, and we think that good will and sound tax collection generally would be promoted.

I just want to tell you one or two other things that have come up, and the sort of things we are advising against here.

Well, in the first place, we think that every effort should be made to have a prompt and sound decision of any disputed question that arises. We think that that will be helped greatly if the taxpayer feels that when he comes before a man, that man is fair; that he is going to decide his question promptly, and if he is a fair and intelligent man, that when he makes the decision the ultimate decision in that case is not going to rest with someone who hasn't had the benefit of a hearing in it at all. We think that the administration of tax laws will be greatly helped if the man who hears the arguments can decide the case. That is just sound in any sort of judicial or administrative practice. We would like to see everything possible done to promote that in the department.

As to the review of disputed cases, where agreements can be reached in the treasury department, we think that the recent suggestions which have been made, some more or less formally and some informally, to make the treasury department the final arbiter of the facts, is a very, very dangerous suggestion.

The people who propose that point to the Interstate Commerce Commission, the Federal Trade Commission, and other commissions in the government whose findings are practically final if there is any evidence to support them. The difference in those commissions lies in the fact that there is a judicial tribunal which has no personal interest in the controversy, sitting off to the side and deciding between two contestants. In the case of a disputed tax case, the treasury itself is one of the parties to the dispute, and it is fundamentally unsound to leave the determination of any question of fact to a party to the controversy. Our committee will certainly do everything in its power to see that no such proposal as that is adopted.

Just summarizing, then, we feel that the promotion on the part of the treasury department of career men who are courageously going ahead making a statesmanship interpretation of the law, and an administration which is not seeking to stop every possible loophole but is seeking to have a generally fair and simple law, which is changed as infrequently as possible, and where every effort is made to see that the taxpayer is put to as little trouble as possible, will greatly help any tax system that we have.

Now, that is the adjective side of the question, and if any of you gentlemen, after reading this report, have any further discussion as to adjective changes which really don't come very much within the scope of the work of this association, we on the committee this year will very much appreciate it if you will pass those suggestions on to us and we will do everything in our power to see that any of those suggestions which are sound are incorporated in our next report to the association.

It didn't occur to me until I arrived at this meeting, but I hope at the meeting of this association next year, if the recommendations of the bar association committee commend themselves to you as sound, we may have a resolution of this association approving them. It would certainly give them added weight and help us inestimably, I should think, in presenting those views to congress and to the treasury department.

I certainly appreciate the opportunity of talking to you.

Chairman Edmonds: Gentlemen, you have heard Mr. Sutherland's very interesting report. Is there any question, debate, or discussion?

This has been one of the longest sessions of the conference. We have been in session more than three hours, but I think all of the audience will agree with me that it has been distinctly worth-while. I take this opportunity to congratulate the audience also upon the interest which it has displayed.

The meeting is adjourned until seven o'clock tonight.

(The meeting thereupon adjourned at 5:20 o'clock.)

THIRTEENTH SESSION

THURSDAY, OCTOBER 27, 1938, 7 P. M.

(BANQUET IN HONOR OF "OLD-TIMERS")

HARLEY L. LUTZ, presiding.

TOASTMASTER LUTZ: The subject of taxation has been dealt with in almost every conceivable manner. Tonight the committee on local arrangements has provided something rather unique, I think, in this line. We are going to try the experiment of having taxation set to music. The gentleman in charge of the songs from 1860 to the present time will now undertake the program for a few minutes, and if you are thoroughly comfortable and relaxed after this splendid dinner, give him a hand. Open up and go to it, and let us see who it was that called that piccolo player a tax expert. Carry on, please.

(Mr. Fowler Smith, director of music education, Detroit Public Schools, accompanied by Miss Gertrude Fleming, supervising director of music, Detroit Elementary Schools, led the group in a selection of old-time popular songs for each decade from 1860 to date.)

MR. FOWLER SMITH (Michigan): This is the best group to conduct that I ever had.

TOASTMASTER LUTZ: I am glad to return that compliment and say that Mr. Fowler Smith is the best singing director that a National Tax Conference ever had.

Also, I am sure there is no doubt now about the tax expert being a piccolo player.

The idea of this banquet in honor of the old-timers originated with Charles J. Tobin. Mr. Tobin has, in fact, worked on this thought for a year or so, and I am sure that as one of the old-timers I voice the sentiment of all of you in expressing our appreciation to Mr. Tobin and the committee for the effort and time that have gone into making this banquet the success that it evidently is.

It is always gratifying for those of us who are approaching the western horizon of life to receive an occasional testimonial before we pass over the divide, instead of its all being saved up for a memorial tablet or a testimonial volume or some other expression of appreciation after it is entirely too late; so again I think Mr. Tobin has exactly the right idea in bringing to the old-timers before it is too late some expression of the way the other membership of the National Tax Association feels about them.

I think also I may speak for the old-timers in saying that it is gratifying to the old guard to understand by this expression of your esteem that we are not held in the same low level of esteem that the old guard has come to be held in some other organizations which might be mentioned. (Laughter) There are places, you know, where the old guard is on the point of being kicked out, or everybody is saying that the old guard should be kicked out, for the best results in the organization.

I think this meeting makes us feel that the old guard and the new recruits in the National Tax Association are standing side by side, and that the newcomers are not eager to throw us as yet into the discard.

Of course, this is as it should be in taxation, if not in some other fields of activity, because the battlefront of taxation has been widening so rapidly that there is plenty of room and plenty of need not only for the new recruits but for the old veterans as well, and since there is such splendid fighting all along the line, I think we can all work together and fight together without anybody getting in anyone else's way, so that you begin to wish that he would get out and give you more elbow-room.

Speaking seriously, I should like to suggest that this solidarity which has characterized the National Tax Association, and which has been so largely responsible for its growth, may be explained, I believe, by the scrupulous observance through the years of the standards and objectives that were set up at the beginning of this organization. I think it is well that we should have these objectives before us, and while they are printed from time to time in our literature, it will do us no harm to recall them once more for the future guidance of the old and the new members alike.

Let me quote the objectives of the National Tax Association: "The National Tax Association has no creed and conducts no propaganda. Its program is mutual education. Its object is to make tax laws simpler, saner, more just, and more effective. It welcomes to its membership representatives of every creed, school, and interest, but its endorsement is given only to those ideas which have the unanimous approval of the voting membership at its annual conference. With these limitations, its declared object is: to formulate and announce through the deliberately expressed opinion of an annual conference the best informed economic thought and administrative experience available for the correct guidance of public opinion, legislative and administrative action, on all questions pertaining to taxation, and to interstate and international comity in taxation."

The distinction between the old and the new is always relative. The National Tax Association was organized in 1907, and we still have with us some of those who participated in the first conference.

The program committee for this meeting has undertaken to draw a distinction between the old-timers, and they established, as they had to in some arbitrary manner, a deadline of service, the old-timers being those whose connection with the association covers fifteen years or more, and the pioneers, or the 'forty-niners of the organization, those whose connection dates to the first five-year period, 1907 to 1911.

On the last page of the special program which was given to you is found a list of some of the pioneers whose connection with and whose activity on behalf of the National Tax Association has continued. You will recognize many of these names, of course. Some of you will remember all of these men who are named here. As the program notes, some of them have passed on, and it is very appropriate that we offer a solemn toast and that we cherish the memory of their friendship and the fine zeal in the many accomplishments of the association.

Some of these pioneers are with us in person, and we have messages from others that will be read later. I should like at this point to ask those of the 1907 to '11 group who are present tonight to rise. I think I can call all of the names, although my program on which I checked these names has been lifted from me by somebody else.

I will go down the list. Mr. Charles Galloway is here. (Applause)

Mr. Joshua Grozier. I thought Mr. Query said he was here, but apparently that was wrong. Mr. George Lord.

SECRETARY W. G. QUERY: He couldn't come.

TOASTMASTER LUTZ: Mr. Lord didn't come to the banquet. He is living here in Detroit. Professor Plehn you will have a chance to see later. I am not going to ask Professor Plehn to join this group now.

Is there anyone else whose name is in this list, whom I have overlooked? Thank you very much.

In concluding my part of this program, may I suggest for the comfort of the old-timers and the encouragement of the young recruits, that this business of growing old has its compensations. Those of us who are in the process and further along in the process than some of the others of you have begun to appreciate that. Our scale of values changes along with our arteries, so we do look at things in a little different way sometimes. All human experience has revealed that the easiest way to grow old, or the best way to grow old easily, is to retain an interest in some hobby, some vocation, or avocation.

I suggest to you men who are growing old in the tax field that you have no more interesting or stimulating field of intellectual interest than that which has constituted your life-work. After we

have received the title "emeritus" and laid down the burden of active administration or study, we shall have in this subject of ours something of enduring stimulation, fascination, and, very often, annoyance!

So I congratulate you old-timers that you have the prospect of an enduring hobby, and you can look forward to a ripe old age of continued study and pondering on taxation problems, because you can take my word for it that they will not all be solved and out of the way, and your hobby will not be taken out from under you just as you have reached that point in life in which you depend upon that to keep you from becoming lost in your wheelchair and your meditations.

The committee has received many fine letters of congratulation from old-timers who could not be with us. I thought it would be interesting if I were to intersperse these letters, some of them—it is impossible to read all of them because they are so numerous—with the speeches.

Before I call upon the first speaker, therefore, I want to read some paragraphs from the letters written by two or three of the men whom you know best and love best and who have contributed as much or more than anyone else to the organization, the growth, and the success of the National Tax Association.

The first letter that I have chosen to read is written on the stationery of Alfred E. Holcomb. (Applause) Mr. Holcomb has written a rather long letter but I shall not read all of it; simply certain paragraphs.

He begins: "It is hardly necessary for me to tell the old-timers who have been my associates for so many years how gladly I comply with the request for a contribution towards the purposes of this session, and that I extend most sincere greetings and best wishes for an enjoyable and profitable conference.

"It is a bit awkward for one who has been for the past thirty-odd years and now is concerned daily with efforts to promote the ideals of this association, to speak as an 'old-timer'."

That is like Holcomb, isn't it? He doesn't want to let go and he doesn't think of himself in that generation.

"We usually look for reminiscences from such a person, and these are apt to be prosaic and uninteresting to those who are obviously and rightly concerned with the present and the future, rather than with the past."

Then the remainder of this communication is devoted to a certain part of the background of the early movement, and with the story of the part which another person, Professor Seligman, had to do with that movement. I will read simply his concluding paragraph:

"The point of all this is to remind you of our debt of gratitude to Professor Edwin R. A. Seligman and to ask that amid your

festivities you remember him as really responsible for the beginning of such success as has crowned the efforts of those who collaborated with him and those who have followed the ideals which he has so ably stated and defended during a long and useful life."

The next letter which I have selected at this time is one to President Leland from Professor Seligman. This paragraph I think you would be interested in:

"I was much touched by your kind letter of October 7th and the invitation to participate in the meeting of the old-timers at Detroit. Unfortunately, I have reached that advanced age where my physicians no longer permit my seizing opportunities of this kind to enjoy myself, but I wish to send you all of my cordial greetings." (Applause)

The third letter to be read at this point is from Professor Bullock, writing to Mr. Tobin:

"I have yours of the 5th and greatly regret that for reasons beyond my control it will be impossible for me to attend the meeting of the National Tax Conference at Detroit. These reasons are that I am recovering from a major operation and shall not be traveling for some time to come. I am getting on well, I think, but traveling is out of the question just now. Best regards." (Applause)

So we have had brought back to us in spirit by these words three of the outstanding men who have contributed so generously and remarkably to the success of the National Tax Association.

The committee has planned for brief remarks from certain of the old-timers and pioneers. They have a very good balance. We have two distinguished tax administrators, a distinguished educator in the field of public finance, and a distinguished leader and research worker in the general field of civic and fiscal reform.

Our first speaker in this short program of addresses will be the Hon. Philip Zoercher, former president of the National Tax Association.

Now, I have done my best up to this point to make the proceedings dull and somber and uninteresting as possible. From now on, since it is going to pass into the hands very largely of the real old-timers, the boys with pep, I am sure that you may expect them to liven up materially.

I remember Mr. Zoercher—how long ago was it, Judge; twenty years, that you started in? You were a young man then, just getting started in the tax field. It has been anyhow twenty years, I think, since the judge first began to come to the tax meetings and talk about the Indiana Plan. (Laughter and applause) The judge hasn't told me what his subject is going to be tonight; but if he wants to talk about the Indiana Plan, I say let us give him a few minutes on that subject, or any subject for that matter. (Applause)

PHILIP ZOERCHER (Indiana): Mr. Toastmaster, Mr. President, Members of the National Tax Association, and Ladies and Gentlemen: For fear that I might talk about the Indiana Plan, I have written down what I want to say. (Laughter and applause)

The first National Tax Conference that it was my privilege to attend was held at Salt Lake City in 1920, and among the tax administrators present who took a prominent part in the work were Niles P. Haugen, chairman of the Wisconsin Tax Commission and president of the National Tax Association at that time. He was succeeded by Zenas W. Bliss, chairman of the board of tax commissioners of Rhode Island. William Bailey, member and secretary of the state board of equalization of Utah, gave a very interesting talk on the work of the Utah Tax Commission.

A. J. Maxwell of the North Carolina Tax Commission and Walter G. Query of the South Carolina Tax Commission were also members of that conference. In fact, it was Mr. Query who, with some of his associates, stopped at Indianapolis to get some information of the new tax law that was enacted in 1919. He called on the governor and urged him to send the members of the board as delegates to the National Tax Conference, and I have not missed a single session since.

In the 1920 *Proceedings* I find a statement made by Hugh Satterlee wherein he referred to the excess profits tax and really advocated the repeal of that law. That was in 1920.

The next session was held in Bretton Woods, New Hampshire, in 1921, and in that session I find that our friend Oscar Leser, who for so many years was connected with the state board of tax commissioners of Maryland, took a very active part in the discussions.

Charles J. Tobin was very active and introduced some very important resolutions, showing that he was a careful student at that time. He has continued in that work up to this date.

Some very interesting papers were read at that session; one on "The Taxation of Land" was a very carefully prepared paper, by Richard T. Ely, director for research in land economics and professor of economics in the University of Wisconsin. The discussion that followed was very interesting—see pages 228 to 300, *Proceedings* of 1921.

At the 1922 session we find a very interesting article by J. G. Armson, member of the Minnesota Tax Commission, on the subject of "Tax Limitations and Other Current Tax Problems with Special Reference to Minnesota."

Walter S. Hallahan, state tax commissioner of West Virginia, gave an interesting report on the West Virginia sales tax, and those of us who attended the annual conferences know that he advertised that sales tax as much as we of Indiana advertised the Indiana plan of controlling expenditures.

Professor Charles J. Bullock of Harvard University was also very active in that session, as he had been at most of the sessions; and, by the way, he was in attendance in 1907 when the National Tax Association was organized. He was active in preparing the model tax law and was always ready to express his opinion on matters in controversy. It is such discussions that lead to improvements.

In that session there was also presented a model inheritance tax law, by Professor Belknap of Kentucky, which showed that he had given careful consideration to that question.

In the session of 1923 we find 69 pages devoted to the subject of real estate assessments, presenting several papers—one on real estate assessments in cities and assessments of farm real estate, and the discussion that followed the reading of these papers is very instructive.

Income and property taxes and the taxing of national banks and federal tax reform and tax-exempt securities were freely discussed in those sessions.

Our friend, Henry Long, tax commissioner of Massachusetts, has taken an active part for many years in the work of this association, being a past president and at present editor of our *Bulletin;* he is performing real service.

Senator Edmonds of Pennsylvania, also a past president, has also taken a great interest in the question of taxation and has done much good for his state.

Take any of the annual reports and you will find interesting and instructive information, and the thorough discussions bring up all matters in controversy. We find the brain-truster, the taxpayer and the taxing officials represented. I hope these professors and instructors in colleges and universities will take no offense at my calling them brain-trusters. I have the highest respect for such because they have given the subject careful study, and while they are sometimes charged with too much theory, they certainly are helpful. The tax administrators have to do with the enforcement of the law and they have done much to bring about a proper solution of matters of taxation. If we would only remember that taxes are necessary to maintain government and that the cost of government must be met with taxes we would and should be willing to contribute our share.

In looking through the volumes we find all kinds of taxes discussed, and I have often said in looking through these volumes you can find information on all kinds of taxes and I cannot understand why there should be so many different organizations affecting taxes. The National Tax Association organized in 1907 has had annual sessions excepting one year during the world war, but I know that since 1920 we have not missed a single year. Those of us who are public officials have come here at the expense of the state

and why should it be necessary to go from place to place when all the tax problems can be discussed and are considered here in the conference of our associates.

Only last week the assessors had a conference at Cincinnati, Ohio, and earlier in the month a tobacco tax conference was held at New Orleans.

Can anyone tell me why this should be? Better stay a whole week if necessary to discuss all subjects, than go from place to place and attend this conference or that conference when it can easily and properly be done at a conference of this National Tax Association.

I know some of my friends may not agree with me, but as public officials we ought to consider the cost to the state, of going from place to place when that could be avoided by discussing all tax matters at one place. The volumes of this association containing the proceedings of the annual conferences are valuable, and will continue to be as long as we continue taking the interest that the membership has shown.

May the good work go on.

MR. ZOERCHER: I want to say now that those of us who have attended all the meetings since Monday morning and have heard the different papers and the different discussions know that the proceedings of the 1938 conference will be one of the most valuable books that we have ever had published. I thank you.

TOASTMASTER LUTZ: I have here a telegram from a member of the association who is well known to all of you, Judge Oscar Leser. He says this:

"Only the exigencies of my sensational campaign (laughter) keep me from the reunion. There must be few older-timers than I am. Little did I realize in 1908 what a wonderful and enduring institution had been born. Please convey to my fellow old-timers and other friends my affectionate regards." (Applause)

Governor Zenas W. Bliss writes in part as follows:

"It is with sincere regret that I find myself unable to attend the 31st Annual Conference of the National Tax Association. It would certainly be a pleasure for me to be present at the banquet in honor of the old-timers.

"With best wishes for a successful conference, and kindest regards to my many friends, I join with you in congratulations on the past and confidence in the future." (Applause)

And from far-away Utah comes a letter from a former president of the National Tax Association, who will be known only to those of you who are old-timers or near old-timers, William Bailey. (Applause)

"Your letter of October 7th inviting me to attend the National Tax Association meeting at Detroit came to me and brought fond memories of the time when I was active in this organization. It is with profound regret that I am unable to attend the conference this year. I have long since learned that the National Tax Association is the strongest factor in the United States as an educational center in the field of taxation.

"Wishing you the splendid success in the future that you have achieved in the past, believe me ever in heart a firm supporter of the National Tax Association." (Applause)

And a note from Professor Fairchild:

"I need hardly tell you how disappointed I am and how much I shall miss this meeting. Please give my regards to my friends and accept my best wishes for a good meeting, which I am sure you will have." (Applause)

Our next speaker on this informal program is not an old-timer but a pioneer, Professor Carl C. Plehn, of the University of California. All of us who began the study of public finance upwards of a generation ago, of course, used Plehn's book on public finance, and we gradually became familiar with his extensive writings of a similar nature in this general field. Perhaps I may say that at the time of Professor Plehn's prime and maturity, I remember that California adopted a constitutional amendment which came down in history, I believe, as Amendment No. 1. Many changes have come to the Golden Gate State since Amendment No. 1 was adopted, and in a week or ten days people of that glorious commonwealth will be voting on another amendment—$30 Every Thursday. (Laughter)

Professor Plehn has not acquainted me with the subject of his remarks, and I extend to him the same privilege as I did to Mr. Zoercher—namely, that he may talk about anything that strikes his fancy, from Amendment No. 1 down to the $30 Every Thursday. (Applause)

Carl C. Plehn (California): Mr. Chairman, and Ladies and Gentlemen: I am not going to be confined to any such narrow limits (laughter) as the chairman has suggested.

About a year and a half ago when I retired from active service in the university, the faculty tendered me a dinner together with one Professor Henry Rand Hattfield, the accountant, and, naturally, I was supposed to be one of the speakers. I prepared a very careful paper, reviewing the history of the department of economics in the university from the days when I was divided between three different departments down to the present, when we have something like fifty members of the department. I read this with great pride to my wife. She took it from me and threw it in the fire. I was a little astonished. She said, "No reminiscences." No reminiscences! Well, I consulted the chairman of the meeting. He said, "Well,

tell a fish story." So I am going to do just that tonight. It may lighten up the proceedings a tiny bit.

Over the door of my fishing lodge in the high Sierras is a little ditty attributed to Elbert Hubbard:

"Behold the fisherman. He riseth up early in the morning and disturbeth the whole household.

"Mighty are his preparations. He goeth forth, and returneth when the day is far spent, smelling of strong drink, and the truth is not in him." (Laughter)

The story I am about to tell is so astounding that if I had not adequate proof I am afraid it would not be believed.

I was fishing one time with my brother-in-law and my son, up above Lundy Canyon in the Sierras. Perhaps you know that when that great block toward the Pacific tipped over and raised the mountains of the Sierras—a very sharp break on the eastern side—it wasn't a straight break at all. There are little canyons running in. Lundy is one of them, one of the most beautiful ones. In that canyon they developed later on the May Lundy Mine, which is perhaps known to some of you, because Mark Twain ran a newspaper up there.

There are three successive shelves there; the first one, I think, is 1,500 feet above the level of the lake formed at the bottom of the canyon, and then there are two shelves higher up. Altogether there are five beautiful lakes up there.

I was fishing up in there in the early season, and the snow hadn't altogether melted, and there was a sort of glacier at one end of the lake, with an overhanging lip. We got up in there and a pretty heavy thunderstorm came along, and there was no shelter—nothing but broken rocks. It was very high up. So we crawled into the lip of this glacier and got shelter from the pelting rain.

But I was still persistent with my fishing and every little while when I thought perhaps there was a trifle of a lull, I would run out and take a cast, then run back again, and hide under the lip of the glacier. Most of the time I didn't get any result. It was raining hard. But pretty soon I hooked a fairly good trout, about ten inches. In my excitement I forgot about the overhanging shelf, and I drew back so sharply that the fish went flying through the air, dropped off the hook, into my fish basket—you know, with the little square holes in the top. It was standing at my feet, and the fish fell right through the opening into the basket, (laughter) without being touched by human hands. If you could only get the taxpayers to do that, wouldn't it be a blessing?

Well, I told this story at the dinner, and, of course, everybody looked skeptical. My brother-in-law was there, and I didn't exactly like to call on him. It might be thought to be too much in the family. But I had young Malcolm Davidson — who has attended

some of your conferences and whom I hope will attend many more—bring in my fish basket, and when the skeptical doubt appeared on their faces, I had him lift it up and I showed them the hole—positive proof of the veracity of my story. (Laughter)

I think, Mr. Chairman, that ought to be enough. (Applause)

TOASTMASTER LUTZ: I am sure you are as fully convinced as I am of the complete veracity of Professor Plehn as a fisherman. (Laughter) The truth is certainly in him; at least, it hasn't come out yet. (Laughter)

I will give you two or three more letters at this point—one from Joseph S. Matthews, a former president of this association:

"I would be delighted to attend the meeting but now think it would be impossible for me to do so, but I will be glad to send a message to be read at the session to which you refer."

A telegram from A. J. Maxwell, a part of which reads as follows:

"Regret particularly inability to attend session of old-timers. Will appreciate particularly remembrance to and best wishes for members of this group. With best wishes for a successful conference and to yourself personally." (Applause)

A letter from a man who was once somewhat more active perhaps than in later years, but who certainly deserves to be ranked among the old-timers, Hugh Satterlee:

"The conferences of the association were always a source of inspiration, and I should be extremely interested to compare the present viewpoint of the members of the association with those existing ten or fifteen years ago. As I look back, I recall that at the meeting in Salt Lake City in 1920 I presented an inordinately long paper on suggestions for simplification of federal taxation, and I am forced to conclude that a paper with similar scope at the present time would require a volume. Hoping to be able to renew my acquaintance with the members of the association at its next conference, I remain." (Applause)

Our next speaker in the order in which the informal addresses are proceeding, is Mr. Douglas Sutherland, long known to many of you for his connection with and his valiant work here in Illinois through the civic federation and the bureau of public efficiency in Chicago. I met Mr. Sutherland first, I think, at Salt Lake City. That was a memorable meeting place. I met Mr. Query there first, Mr. Zoercher—in fact, that seems to be about the time that the old-timers began to gather around thick and fast, so that we can begin to mark our connection from that point on.

I shall leave to Mr. Sutherland the same freedom as to others, as to the subject matter on which he will address you, and I am very glad to present to you Mr. Sutherland. (Applause)

DOUGLAS SUTHERLAND (Illinois): Mr. Chairman, Mr. President, Ladies and Gentlemen: As a humble camp follower of these conferences, I was a good deal astonished and troubled shortly after five o'clock today to be informed that I was to be honored in the very distinguished list of speakers which is being presented to you. Why, I don't know, unless it is because I date back so far in my attendance; while not being quite a pioneer, nevertheless I do go back to 1911 at Richmond.

While old-timers come and old-timers go, and old-timers go on forever, I don't think that is any good reason why discourses should do so, and I am merely going to leave you with a very brief bedtime story, which I am telling by permission.

Once upon a time, somewhat earlier in the present golden age of tax commissioners, there was a highly revered tax commissioner who delighted not only to do justice in rendering decisions upon valuations and assessments such as to bring joy to everyone who practiced before him, as well as to the governments who derived their revenues from the values put on the books, but he was also a very soulful and earnest man who sought to bring about the spiritual uplift of all those with whom he came in contact, and particularly with the gentlemen who came before him in their professional capacity. Privately, he would urge them to improve their lives, as well as their technique in appearing before him, and to abstain from drinking and even from smoking. (Laughter)

He did a lot of moral good, and one of the young men who appeared before him did abstain, and so reported to this kindly mentor that he had succeeded in giving up the vile habit of tobacco. Then came a year when he appeared before him, and one day after the hearing he was sitting in the hotel and the commissioner came up behind him, and the young man was smoking a cigarette. The commissioner said, "Why, Smith, I thought you had stopped smoking." "I have," said Smith, "you have cured me."

Thank you.

SECRETARY W. G. QUERY: Who was it — was that you, Mr. Zoercher? (Laughter)

TOASTMASTER LUTZ: The truth is out. It was Commissioner Zoercher.

Let me give you a final instalment of these very interesting letters that the committee has had. A letter from Henry Herrick Bond, saying, among other things:

"If I have derived very practical help from my membership, how much more precious are the personal friendships that have endured throughout the years. Even if some of these friendships have been cruelly interrupted by death as the years rolled on, new friends have been constantly found at each succeeding meeting." (Applause)

A letter from Robert H. Montgomery:

"I acknowledge your cordial letter of October 12th. Much to my regret, I shall be unable to be with you next week.

"I have vivid and pleasant memories of the old days—the avidity with which we tackled the 1913 income tax law, the many suggestions we made for improvement, and the very occasional adoption of our suggestions.

"I trust the younger men in the association will uphold the old traditions and give careful consideration to and take independent and impartial action on all important tax questions.

"Best wishes for the success of next week's meeting." (Applause)

A final letter from Professor Thomas A. Beal, of the University of Utah:

"I have long appreciated the work of the National Tax Association, because in my judgment it reflects better than any other organization the best-informed opinions on the subject of taxation, both for the nation and for the state.

"It is with extreme regret, therefore, that I cannot be present; but kindly express to the association my best wishes for a successful conference." (Applause)

Time will not permit me to read even any part of the numerous communications which remain in the folder before me. Telegrams or letters containing expressions of sincere good wishes for a successful conference and continuation of the splendid work being performed by the association have been received from the following: Thomas Reed Powell, Mass.; Lawson Purdy, N. Y., Edwin S. Todd, Ohio, Joshua Grozier, Colo., George Vaughan, Ark., John W. Locke, Mass., George Spalding, Colo., Godfrey N. Nelson, N. Y., John E. Brindley, Iowa, Fred T. Field, Mass., George B. Chandler, Ohio, F. R. Carnegie Steele, Mass., Albert G. Milbank, N. Y., R. E. Collins, Calif., J. G. Armson, Minn., C. H. Bradfield, N. Y., C. C. Chapman, Ore., K. M. Williamson, Conn., Laurence A. Tanzer, N. Y., Fred A. Sims, Indiana, E. F. Colladay, D. C., E. P. Tobie, R. I., William H. King, N. Y., and W. L. Beale, D. C. Some of those named above have been members of the association for twenty-five or more years but all of them come within the classification of "old-timers."

The last speaker on our informal list is the Hon. John J. Merrill, New York State Tax Commissioner. You will notice that this does not conform to the printed order of the program. After the program had been prepared, Mr. Merrill communicated to me through the garpevine route, and I learned by that informal method of communication that, for reasons of his own which were not disclosed to me, Mr. Merrill would very much like to have the last chance on this program.

I am very glad, therefore, to give Mr. Merrill the last chance, and he may do with it and with the other speakers, and with you and with me as he will.

Mr. Merrill!

JOHN J. MERRILL (New York): Mr. Toastmaster, Mr. President, Members of the National Tax Association, and Friends—including the ladies, of course: As I have sat here tonight I have had a great deal of pleasure come to me. It so happens that a good many years ago I was born down in the little state of Rhode Island. And I have sat here tonight beside my friend on my left and discovered that he, too, though he comes now from California, was born over in Rhode Island by the Atlantic Ocean. (Mr. Merrill was referring to Mr. Plehn.)

More than a quarter of a century ago when, as the old rhyme runs, I was young and charming, my friend, Alfred E. Holcomb, led me to the portals of this institution which all the years has rendered splendid service to our common country.

Some of those who were then active in the proceedings of the annual conference have met their final exaction, sometimes classified as being the other thing as certain as taxes, but I am indeed pleased to say that many yet remain to lend their services in the attempt to solve the vexing problems now confronting the country.

Let me express my personal pleasure at this opportunity to publicly acknowledge not only my own indebtedness, but also that of the membership of this entire association to the conceivers and the founders of this association. It is impossible at this time to call the complete roll of that early membership, but among the members were Dr. Charles Bullock, Zenas Bliss, Alfred E. Holcomb, for many years the man of general management of this institution; also Dr. Thomas Adams and Frank Zoller, both now deceased.

These men and their colleagues, together with those who succeeded them, contributed in a large measure, both by study and expression, to the work of accomplishment in our tax structure. Had better ear been given to their suggestions and advice, in my humble opinion, we would have been farther down the road to ultimate success. Their efforts were, and are, the more commendable when we consider that nothing strange, highly flavored, or distorted or unjust, found favor with them. In truth, they were in a large measure compromisers. They were so tactful that under certain circumstances they made concessions with the expectation that in the eventual outcome there would ensue something better—something of real worth, not only to the states but to our entire nation.

Some of our hotter-headed younger ones, it must now in the light of more recent events be admitted, were correct in their reasoning, were quietly and tactfully suppressed. This was accomplished largely because they knew from their own experiences that for the time

being such ideas could not be successfully promulgated and brought into their proper position in view of the then generally accepted theories of taxation. Many of these suggestions have since been placed in use, some of them are accepted now as a part of fundamental truths, others have been or are about to be cast into outer darkness, because it has been determined that the premise upon which they were based was largely false in assumption.

It is happenings such as these, that determine the ebb and flow of that stream of tax legislation which has come to be designated as "the trends of taxation." The same procedure by trial and error, proceeds today, and will continue, I assume, until the last syllable of the tale of tax adjustment and tax reform.

I am telling a story which most of you have never listened to before. "Many and many a year ago, in a kingdom by the sea, there lived a"—man, and not a maid, as was sung by Edgar Allen Poe, who at an extremely old age was yet engaged in arduous physical labor.

In the merry month of June, and on a severely hot day, he was engaged in digging a well for Uncle Stephen Babcock. The well-shaft was about five feet in diameter and down about ten feet when Matthew, the digger, found the buried trunk of a tree directly across the line of excavation. He pondered awhile and then clambered forth and sought advice from his employer.

A sharp axe was obtained and Matthew again descended the well-shaft to chop away the tree trunk. After a time he paused to rest and Mr. Babcock said, "Matthew, how do you suppose that trunk landed there?" To this Matthew replied, "Oh, probably in Noah's flood."

"But," said Mr. Babcock, "you, even at your great age, do not remember Noah's flood?"

"No, Mr. Babcock," said Matthew, "'tis only the oldest men now living in Ireland that can remember that flood at all."

So tonight I wish to add my word of praise to the old-timers, our founding fathers, while there are yet a few among us who knew them, loved them, respected them and can still acknowledge the debt of gratitude we owe to them.

I hope and expect that their sucessors will follow in their footsteps, and add a fitting tax superstructure to the splendid foundation which they so bravely laid. (Applause)

Toastmaster Lutz: I thought Mr. Merrill was going to tell us about that tax family, a member of which was bragging about the extreme antiquity of the McDonald family: "The history of the McDonald family goes back into the dim, dim mists of antiquity. In the family history of the McDonald family, along about the middle of the third volume you will find a footnote which says, 'About this time the world was created.'" (Laughter)

The next thing on our program this evening is the presidential address of President Simeon L. Leland.

Before Mr. Leland begins, however, I want to say a word more about the incorrigible optimism of the old-timers who, in spite of their many defeats and their efforts to see a consistency, harmony, unity, simplicity and everything else that their hearts desire brought into taxation, can continue in this seemingly endless struggle without admitting defeat.

Whenever I think of the way in which the incorrigible tax man does keep on with his job, regardless of the number of times that he is slapped down, I always remember a story that I used to hear old Governor Bob Taylor of Tennessee tell, when he and I roamed the wilds of Iowa and southern Minnesota and Missouri on the Redpath Chautauqua circuit.

Governor Bob was a famous story-teller, and I can give you merely the words of his story; I cannot give you the inflection or the emphasis, or make his personality live through it. But the story was something like this, which illustrates the incorrigible optimist.

There was a man he knew who had been a candidate for the legislature sixteen times running, and had been defeated each time that he ran. He did finally get discouraged, and he decided to end it all. He rowed a boat out into the middle of a stream, tied a rope around his neck and hitched the rope over a projecting limb. But to be doubly and trebly sure that there would be no slip-up, he soaked his clothing with kerosene and set fire to them. He swallowed a large dose of poison, and fired a revolver at his head as he kicked the boat out from under his feet. Well, the bullet glanced from his head and cut the rope. He fell into the river; the water put out the fire. He swallowed enough water and strangled so that he choked and coughed up the arsenic. Then he swam ashore and announced himself a candidate for election on the reform ticket. (Laughter)

That is about where we stand, isn't it? We have got to keep announcing ourselves for something or other on the reform ticket in taxation.

President Leland's subject this evening is—I hate to give it to you, friends, but here it is: "The Theory and Practice of Taxation."

I know of no one better qualified than President Leland to give us a very interesting discourse on this subject. You know, of course, by looking at President Leland that he doesn't belong among the old-timers. As a matter of fact, Mr. Leland is only five years older than half as old as Mr. Zoercher. (Laughter) If he were fifteen years older than he is, he would be as old as I am. Those of you who are good at algebra can quickly figure out, I think, just how old Mr. Leland is.

But I do want to say that, despite his apparent youth, Mr. Leland has an old head on him. Therefore, I think we may safely trust to his ministrations this evening this prickly subject, "The Theory and Practice of Taxation."

Gentlemen, I present to you President Leland, of the National Tax Association.

(The members rose and applauded.)

PRESIDENTIAL ADDRESS

SIMEON E. LELAND

The Theory and Practice of Taxation

One of the early American textbook writers in public finance was of the opinion that "there are certain well ascertained and comparatively simple principles to which financial legislation and practice must conform unless disaster is deliberately invited."[1] The search for these "simple principles" has occupied the theorists of our craft for several centuries; attempts to provide wise and effective administration have kept the practitioners busy an even longer period. Another writer, in opening a discussion of "The Theory and Practice of Taxation," remarked that "such a discussion primarily involves the inquiry of how far the varied and curious experience of nations leads up through what may be regarded as a process of evolution, to a recognition of the underlying and essential principles of a just and at the same time an efficient system of taxation."[2] Here is ideological perfection — the coincidence of efficiency and justice.

Our late president, Thomas S. Adams, doubtless would have cynically brushed aside these views. Over a decade ago he was saying:

> "The moralist calls for just taxes; but taxes cannot be just. The administrator calls for simple taxes; but experience shows that they cannot simply be simple. Some politicians would mould taxes wholly in accordance with political expediency; but statesmen realize that in the long run this would be impolitic. The business man demands practical taxes; but financial history proves that it is impractical to make them merely practical. The legalist wants taxes administered strictly according to law; but the record of the income tax and the property tax make it clear that such taxes cannot be successfully administered by methods meticulously legal."[3]

[1] Daniels, *Public Finance*, p. 3. (1899.)

[2] Wells, *The Theory and Practice of Taxation*, p. 1. (1900.)

[3] Adams, "Ideals and Idealism in Taxes," *American Economic Review*, Vol. XVIII, No. 1, p. 5. (March, 1928.)

Hopeless though the search may be, philosophers must hunt for the principles of taxation. Upon administrators rests the obligation to apply them. The course to be followed by theorists and the "practical men" thus coincides for part of the distance to be run. While the theorist is discovering new theories, or developing corollaries for old ones, the administrator is supposed to be busy applying those already known to the solution or execution of the tasks before him. The craft we follow thus appears to have two camps, making common use of certain crude but essential tools. Sometimes the camps work in harmony; sometimes they toil amid strife, noise and confusion; often they pause to debate or call each other names; now and then they do honor to their departed brothers.

An injustice may be done the philosophers and administrators among us by implying that those who follow public finance as a vocation are divided into two or more groups. Clashes between them have been assumed, in conformity, it is believed, to the conditions of real life, but the differences are verbal and the combat is not by ordeal. The views held by members of each group often have common points but few ideas find universal support. There are majority opinions and vigorous dissents here as elsewhere. Characterization is thus difficult; generalization is often unfair. If in these remarks erroneous notions are attributed to any one or to any group, no offense is intended. The criticism of ideas so often leads to criticism of those who hold them — a degeneration assiduously to be avoided—that this warning is issued. Moreover, no one is here being censured or ridiculed; nor their functions in society belittled. The division of labor in the fiscal field provides the state with many useful workers, not all of whom perform the same task. Some think, others act; some plan, others execute; some do both; only a few do neither. The workers far outnumber the drones.

Public finance as a field for intellectual speculation is almost as old as the state itself. The theoretical writings antedate discussion of practices and problems, in the main, because the affairs of the primitive state were generally kept secret, or were regarded as the business of the sovereign. The theories, however, bore the imprint of topics of major concern. When war was the normal order of the day, philosophers considered the means for financing them; when the King ran short of funds, thinkers were concerned with finding new sources of revenue for him to spend; when nationalist states sought to overcome their rivals in foreign trade, scholars speculated upon proper means to this end; when the state undertook the regulation of industry, fiscal students considered these policies; and, when the state endeavored to socialize the production of goods or expand its functions in increasing the amount of social welfare for those governed, philosophers turned their lights in this direction. The changing nature of the state has been accompanied by changes

in philosophical discussion. The struggle for the control of the purse has been the center of democratic evolution. As the people have gained such control, the financial affairs of government have become public business. Facts—rather than hypotheses—have become the materials with which scholars could work. Their writings have become more practical as well as more valuable, but, in large part, they are still primarily deductive in character. With the passage of time and the increasing availability of factual data, inductive and statistical methods of research can be expected to supplement and replace a considerable portion of the traditional didactic discussion.

Though the problems studied have changed from time to time, their fundamental character has remained unaltered. The two major theoretical problems of government — first, what shall government do; and second, how shall the burden of government costs be distributed—have been answered differently from time to time. No answer has been eternal; none has been correct for all places or conditions. The answers depend upon ruling philosophies, dominant economic and social beliefs, as well as upon customs, traditions, and superstitions. Pigou, in discussing public works, remarks: "Should a plutocrat assert that it is more important for him to have a ten-course dinner than for the town to have a swimming pool, there are no dialectical means of refuting him." [4] Nevertheless the state must answer such questions and the related one in taxation of whether it is better for the plutocrat to have the price of his dinner or the state to have the use of what once were his funds.

The major questions of theory are essentially questions of ethics for which we too often seek economic, sociological, psychological, or political explanations. Often the explanations are mistaken for the underlying theories. The division of labor among the philosophers, under which some scholars deal only with economic problems, while others treat only of political science, and still others deal with related fields, further obscures the true nature of many problems. The doctrine of ability to pay, so familiar to students of taxation, is an ethical truism which clashes with the doctrine of direct universal taxation. The whole subject of justice in taxation is an ethical imperative. Only in the republic of Plato, or some similar philosophic state, did it prevail. But what is just has changed from time to time, as the ideas and judgments of men have shifted. If the main problem is ethical, it is social ethics which is involved, for Public Finance is social both in its content and implications. If it makes no difference how the state raises its revenues, it is doubtful if principles of taxation can be identified, if the incidence of taxation need be studied, if the effects of taxation need be noted, if efficient administration is worth developing, if wise expenditure

[4] Pigou, *Economics in Practice*, p. 47.

counts for anything, or if justice is worth considering. The decisions motivating state policy are ethical judgments socially applied. The selection is made through political institutions ill adapted, it is feared, to the task. In democratic societies the decisions are made by counting noses — enumerating those who subscribe to particular beliefs whether sound or fallacious, each vote receiving the same numerical weight as the ballot of the best qualified scholar. Numerically, therefore, the decisions are made by those least qualified to speak. Every one is thus competent to question the advice of the theorist. If his conclusions are derived deductively, his authority is more quickly brushed aside than if statistics must be assembled to refute him. Ethical propositions, however, are seldom capable of statistical verification, hence the common vòter who makes the ultimate decisions is as advantageously circumstanced as the scholar and is his numerical superior in the bargain. He is more competent to decide what he wants government to do for him than he is to decide how the cost should be divided.

From these broad ethical questions the body of theoretical knowledge in public finance passes to the consideration of incidence theory, to rules governing financial legislation, to maxims supposed to guide administrators,[5] to standards by which tax systems may be appraised, to notions concerning the selection of personnel, to ideas about office management, debt payment, and other things. Many notions pertaining to private finance have been boldly applied to government finance without critical evaluation. Old ideas have been recopied, not because of their antiquity, but because new contributions have been scarce. As one of my colleagues has remarked, "Sometimes there is nothing as unsound as hoary doctrines that have acquired the support of authority simply because they are traditional and have stood for so long without genuinely critical examination. One of these mouldy fallacies is that regardless of circumstances the government must balance its budget each year."[6]

Public finance is, however, coming to have a wider scope. The various disciplines in social science are being called upon to contribute ideas to enrich the content of *a priori* discussion. The chief borrowings in this connection have been from political economy, especially in monetary and cycle theory; a recent debt to political science, administration, and law is now due. Much is to be learned from the transfer of knowledge from one field to another, in particular, the verity of the new applications. Scholarship consists in the discovery of new relationships and new phenomena, not in falla-

[5] *Cf.* Sidney Webb in preface to Jones, *Nature and First Principles of Taxation*, p. xiii.

[6] Viner, "Inflation as a Possible Remedy for the Depression," *Proceedings of the Institute of Public Affairs*, University of Georgia, May 8-16, 1933, pp. 128-29.

cious transfers from old fields; science grows through research, not through the imitation of others. This may provide variety or amusement but not truth. It is for truth that the theorist must search.

The division of labor in the fiscal field provides a vast body of practical men—the drawers of water and the hewers of wood. They are the administrators, the tax collectors, the assessors, auditors, lawyers — all, in fact, except the taxpayers, the philosophers, the professors, and the judges. To simplify the discussion let us limit the definition of "practical men"—for this paper only—to the tax administrators. There are plenty of them to provide grist for purposes of discussion. Some of them are trained for their work; others drift into the profession — if that it is — through the law, teaching, or some other vocation; some are transplanted politicians; a few have no qualifications at all. The craft, like all others, is composed of men of all sorts and conditions—by and large a good lot. When the theorists and the public like them, they are called "statesmen"; when they do not, they are labeled "politicians." It is their job to execute the tax policies determined by legislative assemblies, and to discharge many collateral duties, including the giving of advice to chief executives and legislators, much of which is seldom followed. Rarely do they choose the tax laws they must enforce; often they have no voice even in the selection of their staffs. Some come via civil service with merit ratings; some are hired by the patronage dispensers. The conduct of the administrative forces, however, determines the extent and merits of the practice of taxation.

The problems confronting the administrator are generally vital to the functioning of government. The tax revenues must be collected; the assessments and levies, though inequitable, must be made; the evaders must be punished, even if only a few are caught. In short, as imperfect as the performance may be, if the state is to receive revenues, this work must go on. It can not await the improvement of techniques or the perfecting of theories. It must learn and improve as it goes. The situation is not ideal; it merely conforms to the exigencies of the times. If the laws are badly drafted, with obscure meanings, or cumbersome procedures, they must be clarified and made to work. Thus are developed rules and regulations. The spirit of the law is spoken of rather than its words. Patiently, good administrators strive to improve the quality of their executive endeavors; these gains seldom create a public show but they do form the backbone of the morale and *esprit de corps* of the line and staff in well-managed offices. The results become known to the public only as the efficiency of the office increases.

The growing needs of the state and its subdivisions for funds lead to recurrent requests for added revenues. The administrator is constantly badgered into seeking new things to tax, as well as

devising ways to increase the productivity of existing laws. Here and there this sort of advice is also given by the theorist, by the scholar whose research shapes legislative policy. Now and then the practical men and the experts cooperate with legislators and citizens in devising thoroughgoing and well-conceived fiscal plans, but such endeavors are the exception rather than the rule in American states. New York has developed a tradition of careful research antecedent to fiscal reforms, employing the collaboration of experts and practical men. The royal commission in England are also exceptional. Typically the administrator here is called upon to suggest untaxed objects for revenue plucking. Too frequently the legislatures adopt the worst of the proposed alternative measures, whereupon the scorn and wrath of scholarly friends descends upon the administrator of finances. He is blamed for the conduct of the legislature; blamed for the bad advice he gave them; blamed because the revenue system is a patchwork of taxes *in rem* rather than a system designed to measure personal taxable capacity even with rough accuracy. Some of this criticism is unjustified, some is well deserved. There is too much seeking after revenues and not enough effort directed toward the development of tax systems designed fairly to apportion tax burdens. Every time an administrator suggests a tax which is an *ad rem* expedient, the ill-adjusted burdens of such taxation constitute an added economic handicap for the citizens of his state, possibly offset, in part, when the funds are spent. The incidence of tax burdens from the maze of unplanned, uncoordinated but rigidly enforced tax measures is very unequal and haphazard. The administrator too frequently does not seek to correct this condition. His job is to get revenue for the state — if he fails, out he goes. Perhaps it is no wonder he becomes callous to cries of injustice. His training is such — thanks to the lack of opportunity for study and the intricacies of economic reasoning concerning the incidence of taxation — that he seldom knows when the burden is equitably distributed. This, of course, is a problem which mainly interests the theorist, the political economist who teaches government finance; yet the professors are seldom in agreement on their theories and so many are the variables in price determination that in this dynamic world neither the economists nor their statistical friends have been able objectively to demonstrate the distribution of present burdens. "Before and after" comparisons seldom meet the requirements of scientists. "Controlled experiments" are generally impossible in real life. Equilibrium analyses for inductive verification seem to have too large a probable error to allow valid conclusions to be drawn from their elaborate calculations. Hypothetical examples shed little light on total loads or on the distribution of burdens in cases not so identical with those assumed. The economists rely on "long run tendencies" to work out their laws. And, as their theories of price determination differ, so do their laws of the shifting

and incidence of taxation. That they do not agree, is a hope of progress; they should not be criticized for the disagreements—they are still seeking after truth. When they agree, it will be time for the administrator to change his cynicism to skepticism. But little comfort does he get from his gowned friends. No wonder he gladly turns fiscal planning over to them.

The search for revenue leaves its imprints, too, on administrative practice. When funds are needed, revenue agents tend to develop stricter interpretations of the law, increase the rigor and efficiency of audits, or introduce changes in techniques and procedures well calculated to maximize receipts. Often they change official rulings—not to mention the law itself. The taxpayer frequently complains that the tax agents play the game so long as the score runs in their favor but when the government begins to lose, they modify the basic rules. This complaint is frequently well founded. On the other hand, the taxpayer now and then is caught in the path of administrative improvements. The efficient administrator continuously seeks to improve the quality of his work. Changes, as a rule, are slowly and gradually made. As the technicians become surer of their ground their decisions tend to become more preemptory on old controversies and they reach out to extend the applications of their theories. The taxpayer seldom objects so long as all doubts are resolved against the state,[7] but if the change is adverse to him and coincides with a time of reduced business activity, he tends to label the improvement as "poor sportsmanship." And, since all taxpayers are not always similarly circumstanced, a change in any one year will variously affect them. Nor do the taxpayers clearly distinguish between the "poor sportsmanship" of the administrators and *bona fide* efforts to plug loopholes in the law, lessen inequality or thwart outright evasion. These changes must be made, in good conscience, regardless of economic cycles or the feelings of particular taxpayers.

It must be recognized, of course, that some policies undertaken to buttress public revenues involve many logical difficulties, not to say outright inconsistencies. Assessors in depression times hesitate, to

[7] *Cf.* "It will be found generally that if a tax is believed to be practicable over a considerable part of the field to which it is to be applied, and the impracticability is confined to a minor part, most states will embark upon the scheme, and by a sacrifice of logical principle at the point of difficulty and the adoption of a few conventions, will satisfy the equities roughly. This is generally possible if it is so arranged that the state rather than the taxpayers is the loser by it. Do we decline to have an income tax because the farmer finds it impossible to say what his income is? No, but we invent an income for the farmer—giving him the option to pay on less if he can show cause, but in no case charging him more. Do we refuse differentiation because the business man cannot say exactly how much of his profit is interest on his capital and how much is the remuneration of his own work? No, we agree to treat it all as "earnings." Stamp, *The Principles of Taxation*, p. 97.

the very great damage of taxpayers, whole communities, or economic groups, to reduce property valuations as rapidly or as fully as market conditions warrant. The artificial maintenance of assessments creates an economic handicap to business, prevents more rapid price readjustments or more rapid recoveries, and creates other difficulties familiar to students of problems relating to fixed or overhead costs. Some assessors, seeking refuge behind the uniformity of their practices, close their eyes to the economic consequences of their acts. Some even attempt to convert *ad valorem* taxes into income taxes, or transform transaction taxes into customs duties. Violations of principle involving changes in the essential nature of particular taxes can hardly be justified in the interest of maintaining the ordinary revenues of the state.

The administrator is not to be chided too glibly for his alleged insistence on productiveness in taxation. Numerous theorists likewise insist upon fiscal adequacy as the prime canon of taxation.[8] One dissenter writes:

> "Productivity can scarcely claim to be a principle of taxation at all. If it means that the first essential of a tax is that it shall produce money, it is a useless truism. A wheat farm must produce wheat, but that is not a principle of farming; it is the object of farming, as money-getting is the object of taxing."[9]

The merits of this controversy cannot be settled by the dialectics of definitions of "objects" or "principles." The issue is deeper. It relates to the support of the state, on the one hand, by inequitable taxes fiscally productive and, on the other, by the maintenance of the state by equitable imposts with more limited revenue propensities. Often the choice is simply between good and bad taxes, productivity being assured in either case. If a state can be supported only by inequitable taxes, it may be queried whether such a state is worth preserving. To continue its existence when it is supported by inequity is to give the state an existence separate from that of its subjects and to divorce its existence from their welfare. Yet so great is the social importance of the modern state that, with Adam Smith, it must be agreed "that when the *wisest* government has exhausted all the *proper* subjects of taxation, it must, *in cases of urgent necessity*, have recourse to improper ones."[10] This departure from just taxes, however, is sanctioned only in an emergency. Moreover, the line is not a sharp one; the choice is between tax devices that are more or less just, whatever the measure of

[8] *Cf.* Bastable, *Public Finance*, pp. 417-18; Shirras, *Public Finance*, 1st ed., p. 128.

[9] Jones, *The Nature and First Principles of Taxation*, p. 156.

[10] *Wealth of Nations*, Bk. V, ch. iii. Italics my own.

justice. Fortunately, when many equitable methods of raising public revenues can be found, there is no excuse for allowing the state to seek refuge behind a canon of fiscal expediency, bulwarked by cowardice and tradition. It would seem that the time has come when a just, as well as a coordinated, tax system should be developed for the American nation! Our federal system was never designed for such colossal tax burdens collected from all sorts of objects on all sorts of occasions by all sorts of political units (too numerous to mention). Nor is it conceivable that such tax burdens should be collected without reference to the taxable capacity of those governed or the incidence of the burdens imposed. The economic consequences of such burdens are a permanent handicap to economic welfare. Many jurisdictions continue to support themselves by worn-out and discredited fiscal devices. Our states have matured into a nation but our tax system is no system at all. It is not designed even to meet fairly the requirements of petty commonwealths. The time for serious fiscal planning by the nation and its states, by the administrators, the scholars, and the citizens, has arrived. If the national government does not soon assume leadership here—and it has been dilly-dallying with the problem—a convention of states should undertake the development of a fiscal program for the nation. The burdens of taxation are too severe to justify their continued maldistribution. The need for revenue for debt retirement, rearmament, and the program of social welfare during peace time, necessitates the development of a productive and a wise tax system not alone for the central government but for the state and local units as well.

It is not hard to pass from the point of view that taxes should be mainly productive to the opposite belief that revenue is of minor concern—that it is the effects, the non-fiscal uses of taxation which are important. As the administrator has been interested in revenue-productivity, so the theorists have tended to advocate the use of taxes for economic, social, or other ends. Since taxes do have these effects inevitably, why not harness the tax system intentionally to produce them? Taxation then becomes an instrument of social control, one of economic power, or one of political domination. It is Machiavellian in the sense that the end justifies the means. If consumption of alcohol or tobacco is injurious, the advocates of sumptuary taxation argue that they can improve man's lot and the cash position of the treasury by so increasing the price of these articles through taxation that smaller quantities of them will be sold. The difficulty too frequently is that the articles selected for such treatment seldom have an elastic demand—that is, price changes have relatively little effect on sales. Or, if the distribution of wealth is inequitable, it may be corrected through progressive taxation. Property accumulation, the evils of inheritance, or lags in philanthropy can be corrected by accelerated inheritance and gift taxation. Polit-

ical power not directly conferred on governments may be exercised indirectly through the taxing power if non-fiscal uses receive judicial sanction. Where governments may not be able directly to regulate, they may nevertheless tax those who otherwise would be controlled. If this power is limited there yet remains the collateral power of expenditure, making possible subsidies, pensions, or grants-in-aid for purposes important to the grantor-government. Whether the taxing power may be employed for non-fiscal uses is a legal question; whether it should be so used is another ethical dilemma. We tend to answer the ethical question in terms of our belief in the social or economic utility of the objective. Perhaps the more appropriate question is whether we are qualified to make the decision. What are the standards of judgment? What are the techniques by which it may be decided what are the appropriate ends legitimately to be sought in our society? That we pretend to know where we are going and by what routes involves some conceit. Fiscal theory thus easily crosses into the fringe of reform.

What is valid theory and sound practice is not always easy to determine. The zone between them is continually changing. One shades into the other as knowledge grows. Once progressive taxation was both a theoretical and an administrative heresy; it now rests on a solid foundation in both fields. The present skewness in the distribution of wealth makes these taxes highly productive. Some practical men prefer the regressive sales taxes to progressive income taxes as producers of revenue, but, due to exemptions in the one tax and the lack of them in the other, the customary conclusions as to the superior productivity of sales taxes are erroneous, or at least unreliable.[11] As to the wisdom of using sales taxes, the theorists and administrators are often in disagreement. The difference of opinion grows as administrators seek to plug what appear to be loopholes in the laws. Their efforts often involve conflicts of opinion over economic policies. Sometimes they affect freedom of trade, opportunities to earn a livelihood, or the right to produce goods and services. Many an economic fallacy unfortunately has the support of fiscal administrators. Zeal to prevent tax evasion often leads to fiscal mercantilism. It is necessary to remember in this connection that the economic burdens of such policies generally fall on the residents of the states which adopt them. The ability of a state to impose economic burdens on non-residents is fortunately limited. The implications here refer in considerable part to the consequences of fiscal policy. The theorists naturally have greater insight into them than others, yet their warnings are too generally ignored. Administrators like to settle issues relative to the choice of taxation devices by reference to fiscal maxims. The important decisions relate rather to effects of tax policies on production, con-

[11] See Jacoby, *Retail Sales Taxation*, pp. 230-32.

sumption, saving, investment, standards of living, economic motives and social welfare. The theorist is supposed to have special abilities—if he is qualified for his work—to sketch the methods by which chosen objectives can be attained in practice. The administrator is best qualified not to chart the course of fiscal evolution but to build the operating structure and make it work. It is important that the specialization of each be respected and that their recommendations be limited to the fields of competence. When advice is given by each group in every field, the babble of tongues is confusing, choices become difficult and disagreements ensue. The state must decide which advice to take and attempt to reconcile the differences of opinion.

If we can transform administrators into scholars and can direct the attention of fiscal philosophers to the practical problems which bother administrators, the alleged conflict between theory and practice in taxation can be changed to fruitful cooperative research through which public finance will grow. Trial and error in practice can be replaced by action based on research. The theorist can work on problems of vital concern to the state, can become more practical, for his theories will be given a pragmatic test. Heretofore, the difference between theory and practice has been, in the mind of the average citizen and the administrator, a difference of opinion as to results. If the end was approved the point at issue was practical; if the result was questionable and no other objection could be quickly raised, the thing was "all right in theory, but wrong in practice." [12] This really meant that the result was not liked though it was not known precisely why. When both the theorists and the practical men work on the same problems their understanding and appreciation of each other will grow. The administrator will get a better foundation for his practices than "what he learned in youth before practical activities absorbed him." [13]

[12] Cf. "The first argument that is brought against every new proposal departing from conventional lines is nearly always that it is "impracticable." No one alleges that it is impracticable to raise the rate of income tax, estate duty, or tea duty, but if some one proposes graduation or differentiation, there must be an inquiry as to whether it is *practicable*. Can it be worked? This question follows directly upon proposals for preferential tariffs with drawbacks, tariff with *ad valorem* charges, luxury taxes, turnover taxes, capital levies, levies on war wealth, graduated taxes on business profits, and so on. Many a proposal that is clear and equitable in theory is beyond administrative ingenuity to work. Many thought that differentiation between earned and unearned income could not be worked, but certain difficulties were gotten over by what was frankly a compromise or concession. The crucial case was the business worked by its owner, when it had to be decided how much of the profit was interest on capital and how much was earnings. The difficulty was met by calling it all "earned." The rest of the field of administration was compassable and lent itself to regular rules easily applicable." Stamp, *The Principles of Taxation*, p. 95.

[13] *Cf.* Pigou, *Economics in Practice*, p. 25.

He will learn better to evaluate the *ex parte* arguments presented to him by those with advantages to gain. Now he is often unable to distinguish the true from the false, or those which will work toward a desired broad objective of social policy from those that will work against it. His training has been limited, his time for scholarship has been even more limited, the remuneration offered has been too small long to detain him in the public service or to attract stimulating scholars as colleagues or assistants. If, however, he can aid or cooperate with his academic colleagues, such shortcomings can be overcome. The theorist, too, has much to gain from the association. His facilities have been limited, the data with which to work have been fragmentary compared with the potential store of available material; funds for research have been scarce. Hence, those who like philosophical speculation have made use of what tools and such materials as were available. They have worked on problems pleasing to them. If now the administrators and the scholars can work together, the frontier of knowledge can be extended and the rôle of expediency or custom in practice can be replaced by sound policies resting on research.

Both the field of tax administration and fiscal philosophy need scientific investigation. Too much theory has been copied from previous books, too much transplanted from other fields. Too much of the practice has been along the lines of least resistance, too much based upon keeping the hen from crying out; [14] too much of the progress "in the right direction" has been too slow.[15] We should, nevertheless, be both charitable and patient, for fiscal practitioners and scholars are as infirm as other humans. Nevertheless, we cannot rest the case here. Both theory and practice must be improved by further study and research.

Leadership in promoting such study can best be assumed by this association, embracing, as it does, both the practical men and the academicians. All have long seen the need for careful investigation of tax problems. Together they have worked on discussions of important topics and on carefully considered committee reports dealing with vital problems. The work of the model tax plan committee is indicative of what can be accomplished here. The present committees of the association, linking theorists with administrators and taxpayers, should also be conspicuous for their accomplishments. Pure research, however, has never been undertaken by the association. That is costly and funds have been scarce. Such work has been left to educational institutions, private agencies, and a few

[14] "The object is, as the saying goes, to pluck the hen without making it cry out . . ." Turgot, in Letter to Hume, September 7, 1766. Ashley Ed. of *Riches*, p. 103.

[15] But compare "No ideal is attainable in the domain of finance; all that is possible is to move a few steps in the right direction." Pierson, *Principles of Economics*, Vol. II, p. 464.

state departments. What is needed is a linking, through research endeavors, of the theorists and administrators with other practical men. Perhaps the association can encourage states to create research bureaus in their fiscal departments to which scholars can be invited; perhaps public officers can be encouraged to send their brilliant subordinates to work "on leave" with the philosophers; perhaps the association can interest philanthropists in the need for research into fiscal problems and indicate the vast store of problems awaiting attention. Fiscal problems are today the problems of greatest national concern. Social welfare and continued economic progress depend upon their proper solution. Perhaps the association with its modest treasury can encourage some little research; perhaps it can create fellowships available to brilliant youths who seek further light on fiscal problems; perhaps it can help administrators to get leaves of absence for study with eminent men here and abroad; it might even encourage self-education through travel and personal contact so that one state may learn about the lifeblood by which other states live. Perhaps if those here assembled get interested in prying more deeply into the respective fields and comparing knowledge thus gained with what those in adjacent fields have learned, a real beginning will have been made. We grow through the search for truth—that is the mission of the philosopher and the obligation of the practitioner in taxation.

TOASTMASTER LUTZ: I am sure we are all indebted to President Leland for this extremely interesting and stimulating paper. His contrast between theory and practice reminded me of what Professor Taussig used to say when I was at Harvard, in the days when he often went to Washington to appear before a congressional committee engaged in revising the tariff laws. He said that whenever he made a statement with which the committee agreed, he was referred to as "the eminent authority," and whenever he said anything with which the committee disagreed, he was "a damned theorist."

In a moment I shall adjourn this part of the meeting, but before we do that I think it is entirely fitting and appropriate that we should give to Mr. Tobin and his committee a rising vote of thanks for the effort and the successful result that has been demonstrated. Will you please do that for Mr. Tobin?

(The members rose and applauded.)

TOASTMASTER LUTZ: Thank you.

The National Tax Association is capable of executing quick changes, as you know, from time to time, and we are going to witness one of those big changes in just a moment. But I want to see if we can take it. We shall have, after I relinquish the command here, a short business meeting of the National Tax Associa-

tion. We are very fond of coming to these conferences and spending long periods of our time in criticizing citizens. We may say that they never go out to attend the budget meetings, they don't care anything about finances of their municipalities except when the taxes get too high. Now you will hear at this business meeting the financial report of the National Tax Association.

We say also that the citizens pay very little attention to the officers who are elected to administer their affairs. We are also going to have an election of officers at this business meeting of the National Tax Association. I presume inevitably there will be a short recess between our adjournment and the call to order of the National Tax Association. Are you going to put your theory into practice or are you going to leave the usual corporals' guard for the business meeting of the National Tax Association?

The meeting is adjourned.

(The meeting thereupon adjourned at ten-fifteen o'clock.)

ANNUAL MEETING OF THE NATIONAL TAX ASSOCIATION

THURSDAY, OCTOBER 27, 1938, 10:20 P. M.

PRESIDENT LELAND, presiding.

PRESIDENT LELAND: By such authority as now is left in me, I want to call the 1938 Annual Meeting of the National Tax Association to order.

The official notice for the call of this meeting was published in the June *Bulletin* and was mailed to our members by the secretary. That constitutes the call and the legal notice of this business meeting.

Mr. Secretary, is there a quorum present?

SECRETARY W. G QUERY: There is a quorum present.

PRESIDENT LELAND: The first order of business is the report of our treasurer, Mr. Eby.

NATIONAL TAX ASSOCIATION

REPORT OF TREASURER YEAR ENDED JUNE 30, 1938

RECEIPTS AND DISBURSEMENTS

Balance in bank July 1, 1937		$2,014.86
RECEIPTS		
Association Activities		
Dues	$6,000.00	
Sales of publications	380.43	
Subscriptions to *Bulletin*	122.00	
Miscellaneous receipts	5.00	
Total	$6,507.43	
Investment Income		
Interest	$1,406.37	
Dividends	199.35	
Total	$1,605.72	
Special Contributions	$2,155.00	
Redeemed Bond	$1,000.00	
Total receipts		$11,268.15
Total balance in bank and receipts		$13,283.01

DISBURSEMENTS

Administrative		
Secretary—Clerical services	$1,500.00	
Postage, printing and stationery	285.27	
Miscellaneous	15.95	
Total	$1,801.22	
Proceedings		
Printing Vol. No. 30	$2,787.10	
Reprints	64.67	
Total	$2,851.77	
Bulletin		
Printing Vol. No. 23 (Nos. 1-8)	$1,539.36	
Reprints	16.78	
Total	$1,556.14	
Conference		
Reporter—Minutes	$ 296.24	
" —Expenses	40.00	
Printing and postage	71.62	
Traveling expenses	49.50	
Total	$ 457.36	
Miscellaneous		
Rental of safe deposit box	$ 8.25	
Exchange on checks deposited	2.58	
Total	$ 10.83	
Funds Invested		
Cost of bonds purchased (less interest accrued)	$2,055.00	
Total disbursements		$ 8,732.32
Balance in bank June 30, 1938		$ 4,550.69

From this statement of receipts and disbursements is summarized the following:

INCOME STATEMENT

Association Activities

Income	
Dues, sales of publications, subscriptions to *Bulletin* and miscellaneous receipts	$6,507.43

Expense	
Administrative, proceedings, bulletin, conference and miscellaneous expenses	6,677.32
Excess of expense over income	$ 169.89

Investments

Income	
Interest and dividends	$1,605.72
Net income	$1,435.83
Special contributions	2,155.00
Net income and special contributions	$3,590.83

NET PROFIT ON REDEMPTION OF BONDS

During the year, one bond which cost $971.25 was redeemed for $1,000.00, resulting in a net profit of $28.75.

CHANGES IN INVESTMENT SECURITIES

Book value of securities owned July 1, 1937		$33,329.42
Cost of bonds acquired	$2,055.00	
Book value of bond redeemed	971.25	
Net increase		1,083.75
Book value of securities owned June 30, 1938		$34,413.17

ROBERT J. EBY,
Treasurer.

REPORT OF AUDIT

I have audited the accounts of the National Tax Association as maintained by the treasurer for the year ended June 30, 1938, and verified the securities owned as at that date by personal examination. All cash received during the period, according to reports and other records in file, was found to have been deposited in bank to the credit of the association, and all disbursements were supported by receipted bills or other satisfactory data.

Subject to the foregoing, it is my opinion that the appended report of treasurer correctly sets forth the results of the association's activities for the year, and the balance in bank and investment securities owned as at June 30, 1938.

EDWARD F. NEAL,
Auditor.

NEW YORK, NEW YORK
OCTOBER 21, 1938.

ROBERT J. EBY: I may say that this report has been approved by the executive committee today.

PRESIDENT LELAND: Are there any questions that anyone would like to ask the treasurer? One reason we had this meeting tonight instead of the last night of the conference, when everyone is ordinarily thinking about going home and others have gone home, is that many of you could learn about the affairs of the association and if you had questions could ask them, or, if you wanted to express opinions, you could do that.

The accounts of the treasurer have been audited. They have been accepted and approved by the executive committee.

What is your pleasure with respect to the treasurer's report?

CHARLES J. TOBIN (New York): I move it be accepted.

(The motion was duly seconded.)

PRESIDENT LELAND: Is there any discussion? All in favor, say "Aye."

(Ayes.)

PRESIDENT LELAND: Opposed, "No."

(None.)

PRESIDENT LELAND: It is unanimously approved.

We will now have the report of the secretary.

SECRETARY W. G. QUERY: Mr. President, the report of the secretary covering the activities of his office for the year ending June 30, 1938, is a repetition of previous reports, and therefore will be brief.

The duties of the secretary include handling details in connection with the sale of publications, the collection of dues, and subscriptions to the *Bulletin*. Delinquent memberships increase the work materially, and comprise the most perplexing problem of my duties.

We secured, during the year ending June 30, 1938, one hundred and thirty-five new members. But there were sixty-two cancellations during that same period, and at the end of June 30, 1938, I still had forty-five delinquent cards in my file, which will be cancelled if the dues are not collected here or received by the time I get back to my office.

The net increase, however, was slightly above that of the previous year. We have now in excess of 1200 members.

The publication of the proceedings, a long and laborious task, as some of you know, and the preparation of the annual program, with the exception of this year, comprises much of the work done by the secretary and assistant.

I want at this time to make grateful acknowledgment and give due credit to President Leland for the splendid work that he did in

the preparation of the program that is being presented here this week. With the assistance of members of the committee in small part, he has put on what I consider the very finest program that we have had in many years. Thank you.

PRESIDENT LELAND: Any comment on the secretary's report?

PHILIP ZOERCHER: I move it be approved.

(The motion was duly seconded.)

PRESIDENT LELAND: All in favor, say "Aye."

(Ayes.)

PRESIDENT LELAND: Opposed, "No."

(None.)

PRESIDENT LELAND: It is unanimous.

The next order of business is the most pleasurable part of this business meeting, the report of the committee on nominations for officers for next year, to be presented by the chairman of the nominating committee, Professor Lutz.

HARLEY L. LUTZ (New Jersey): Mr. Chairman, the committee on nominations submits the following report: we recommend the election of the following persons to the offices and for the terms specified:

For officers, to hold office for the ensuing year and until their successors are elected:

President, Alfred H. Stone, of Mississippi;
Vice-President, Charles W. Gerstenberg, of New York;
Secretary, W. G. Query, of South Carolina;
Treasurer, Robert J. Eby, of New York.

For members of the executive committee for terms expiring in 1941: Roger J. Traynor, of California; Raymond H. Berry, of Michigan; and Norman McDonald, of Massachusetts.

For honorary members of the executive committee from Canada, to hold office for the ensuing year and until their successors are elected: L. I. McMahon, of Montreal, and A. K. Eaton, of the department of finance of Canada.

The committee moves the election of these persons to the offices specified.

PRESIDENT LELAND: Is there a second to that?

(The motion was duly seconded.)

PRESIDENT LELAND: Are there any nominations from the floor?

There being none, all those in favor of the report of the nominations committee and the authorization of the secretary to cast one ballot for their unanimous election, will respond by saying, "Aye."

(Ayes.)

PRESIDENT LELAND: Opposed, "No."

(None.)

PRESIDENT LELAND: It is unanimous.

Mr. Secretary!

SECRETARY W. G. QUERY: Mr. Chairman, I now cast my ballot for the nominations herein contained.

PRESIDENT LELAND: It having been cast, these officers whose names you have heard have been duly elected. It will give me great pleasure to hear a few words from our newly-elected president, who will not receive the gavel of his authority until one month from this date.

Mr. Smith, will you escort our new president to the rostrum, that he may be seen but not heard very long.

May I congratulate you on your election?

PRESIDENT-ELECT STONE: Mr. President, Mr. Chairman and Members of the Nominating Committee, Ladies and Gentlemen: It would be a foolish undertaking for me to attempt to express my appreciation of the very great honor which you have just conferred upon me. I say that not in any perfunctory way but from the depths of my heart. We have no badges of aristocracy in this country; we have no established and inherited orders of nobility. I frequently have thought in the various years that I have attended—I have not been a regular attendant, but a number of times I have attended conferences of the National Tax Association — that the names of the presidents of this association constitute a roll of honor. I don't know of any group more entitled to distinction, more entitled to the appreciation of the thoughtful people of America, than the men who have presided over the affairs and destinies of this association from time to time.

I appreciate more than I can tell you the very great distinction you have given me, in allowing me to become a member of this great company. I am not going to make a speech. My friend Harley Lutz made some reference to something he was reminded of by the address of our distinguished president a while ago. I am not coming down from the sublime to the ridiculous, but I just can't help it. It reminded me of something, too, this matter of the difference between the theory and the practice of things.

One of my very great friends and a man who was a very great member of congress from my state was Private John Allen. Private John Allen served in the civil war throughout the entire four years, and he claimed down to the time of his death that he was the only private in the Confederate Army.

When he ran for congress, which he did several times, and was always elected, he was opposed the first time by a very distinguished Confederate General, General William F. Tucker, of my state. General Tucker was something of a theorist. Private John Allen was intensely practical, in politics and everything else, and on the memorable occasion when they had their first and only joint debate, General Tucker led off with a discussion of theories of government, theories of taxation, and all the things which he would do if he were elected to congress, not only for the state of Mississippi but for the nation at large and for our then newly-reunited country.

In the course of this discussion—and he made a very able speech, because he was a very distinguished lawyer as well as having served in the capacity of a brigadier-general in the Confederate Army—in a very eloquent way he told of the eve of a very great battle in which he took part as a brigadier-general. He told of how cold and dreary and miserable the night was. He spoke of the sleet that beat down on his tent as he lay there and couldn't sleep on his cot because he listened to the pacing up and down in front of the sentry who was appointed to stand guard over him during the night.

He described the whole thing in all its horror, and how he thought of what was going to take place and of the carnage that was going to ensue the next day and the lives that would be lost, and all the rest of it. He made a wonderful impression.

He was followed by my intensely practical friend, Private John Allen. He said, "I want to agree with everything that General Tucker has said to you about the eve of that battle. I am not concerned with his political theories and his academic ideas, what he is going to do to alleviate taxes and all that. But I am very much interested in what he told you about the night before that battle."

He said, "He hasn't told you half of it. He couldn't tell you all of it, because when he spoke of listening to that sentry pacing up and down in front, he was talking about me. I was the boy who was carrying the gun that night out in the rain in front of General Tucker's tent, and I want to submit to you a practical proposition. All of you who slept in tents that night, all of you who had the dreams that General Tucker had, all of you who were generals vote for General Tucker. All of you who sat out in the rain and couldn't sleep at all, you vote for Private John Allen." (Applause)

President Leland: You have heard a few words from our president-elect, who will take office in thirty days.

Mr. Long, by such authority as is left in me for the next thirty days, I appoint you as a committee to notify our vice-president-elect that he should present himself at this rostrum and be notified of his election and elevation to the illustrious office of vice-president.

Mr. Long: If I can find him, I will surely do that.

President Leland: Mr. Gerstenberg, by the authority which resides in me for thirty days, it is my pleasure to notify you of your election as vice-president of this association and to authorize you to be able to consume almost as much time as Mr. Stone did. (Laughter)

Mr. Gerstenberg: Mr. President, and Ladies and Gentlemen of the Association: I shall only say a word. I worked for this association before I became a member. I wrote a paper ten years before I became a member, and sent it 2,000 miles to be read at the Denver meeting. I wonder if any of you recall the story told by Mr. Walter Head of St. Louis, at the St. Louis meeting in 1924. Mr. Head afterwards became president of the American Bankers Association.

A business man of St. Louis became very feeble, from too much work. The doctors told him he would have to rest, and that he would have to go to the West Coast to get away from details. So out to the coast he went. But at each station a bag of mail was put on the train, addressed to him, John Brown. When got to the coast he found mail that had been sent by airplane. He struggled with it, and finally gave up, saying, "This is worse than being at home. At home I could at least have the assistance of a number of secretaries." So he went back, back to St. Louis, and the prediction of the doctor came true—he died.

Being a good man, he went to heaven. He found peace at least. "This is beautiful," he said. "I have never seen or experienced such beauty, such quiet. At last I have achieved the reward promised to good workers."

Then he heard a faint voice, 'way off in the distance: "Mr. Brown," it called. It came closer. Finally, he looked around and there was a sprightly diminutive angel.

"I am looking for Mr. Brown," it said.

"Well, I am he."

"Mr. Brown, you are wanted on the ouija-board." (Laughter)

I worked for the National Tax Association before I became a member; I shall continue to do so till the end—and, who knows, perhaps beyond. I thank you for the honor you have conferred on me.

President Leland: That reminds Mr. Stone of a story.

Mr. Stone: No. I am not going to impose on you with any story. But I want to serve notice on you that you needn't expect me to live up to the example set by this young man here (referring to President Leland). I don't know anybody who could do as good a job as he has done. I certainly can't. One of the things which makes it possible for me to go ahead and feel that possibly I can accomplish something is that he has promised me his assistance, as

has Walter Query, and I know I will get it from all of you, to say nothing of my good friend Mr. Gerstenberg.

But I feel a genuine affection for Simeon Leland, and if I can just do half as good a job as he has done I will be satisfied.

President Leland: We have heard from our president-elect and vice-president-elect. There is no use hearing any more from the treasurer. All those who have paid their dues have already paid them. There is no use hearing any more from the secretary, because he will be around here tomorrow. There are no other officers in the room to be notified. They will be notified by mail.

Is there any other business to come before this meeting of the association before it is declared adjourned, upon due motion by the members duly seconded and recorded? Is there any business?

L. I. McMahon (Montreal, Canada): Mr. President, just before adjournment may I express the thanks of Canada and the representatives you so kindly elected in the persons of Dr. Eaton and myself, and I assure you that we will work our very best for the closer relationships that you and the others have so much at heart.

Thank you.

President Leland: I may say, Mr. McMahon, that at the meeting of the executive committee to day, the association has taken some steps to cement and improve that relationship.

Is there any other business? Are there any other spirits who feel moved to speak?

Mr. Zoercher: I move we adjourn.

(The motion was duly seconded.)

President Leland: All in favor of adjournment, say "Aye." The meeting is adjourned.

(The meeting thereupon adjourned at 10:55 o'clock P. M.)

FOURTEENTH SESSION

FRIDAY, OCTOBER 28, 1938, 9:30 A. M.

PRESIDENT LELAND: Our program looks as though it is going to be very interesting, and if we are to do the subjects justice, I think we must start.

The general topic this morning is "Inheritance and Gift Taxes" and I will ask my good friend, Melvin McPherson, of the Michigan Tax Commission, former chairman, now member of the commission, to preside at this session. We have had a grand time in your state, Mr. McPherson, and I think it is important that you should be able to wield the gavel as we bring the session to one of its high points. It is a pleasure to have you take charge.

M. B. MCPHERSON, presiding.

CHAIRMAN MCPHERSON: President Leland and my good friends from the other states: This morning in opening the session, I want to say to you that tomorrow up at Ann Arbor my football team is going to play President Leland's team. Up at East Lansing, Santa Clara is going to play Michigan State, and while you are in Michigan, or on your way back home, it might be worth while to stop at one or both of these places and see your team play.

We mentioned something about that when we met in Oklahoma City and Indianapolis and again Baltimore, and I found out long ago that, of course, as a tax commissioner we are never in politics; but as I have visited the football games, I couldn't help but think if every session every man who has anything to do with the spreading and collecting and levying of taxes could go to two or three good football games and watch and see what sometimes a man's own interference will do to him in preventing a touchdown, and what some good interference will do in helping him make a touchdown, it might be a lesson for all of us.

With those brief remarks along the line of taxation, I think we are ready to take up the program.

FRANKLIN S. EDMONDS (Pennsylvania): That is one of the best speeches on taxation I ever heard.

CHAIRMAN MCPHERSON: I don't want to bring in the new president's method of assessing railroads because we have been accused of that in Michigan during the last two years by one of our major railroad companies. That rule of 2 that he had, where he said every railroad was as wide as the other so they started even on the first factor—something like that, wasn't it?

The first subject is "State Gift Taxes" by Mr. Lowell Harriss, instructor in economics, Columbia University, New York.

Mr. Harriss!

STATE TAXATION OF GIFTS

C. LOWELL HARRISS
Instructor in Economics, Columbia University

At least a dozen states have given serious attention to the problem of whether or not they should enact a tax on gifts. This paper will try to discuss briefly some of the more important considerations that other states should take into account in planning their tax systems. Because each state's problems are to some extent peculiar, no definite conclusions applicable to all can be reached. Some useful purpose may be served, however, by summarizing the present situation and some experience of jurisdictions which have a gift tax.

Reasons for a Gift Tax

INADEQUACY OF DEATH TAX PROVISIONS

No one familiar with the history of inheritance and estates taxes in this country will have any illusions about the effectiveness of attempts to tax *inter vivos* gifts as part of the estate passing at death. Sections in the laws providing for the taxation of gifts in contemplation of or to take effect at death have been more effective in some jurisdictions than in others, but any study of the cases should leave little doubt that vast amounts of the property of one generation passing to the next have escaped payment of transfer tax. These cases indicate that many wealthy citizens have often so disposed of their property as to relieve themselves or their heirs of part of the burden of supporting government.

While the present trend of decisions is somewhat more favorable to the government than it has been in the past and the most restrictive definitions of "contemplation of death" no longer stand, it is well to bear in mind that even now the facts must be very clear before the government can win. One is apt to be struck in reading the cases not by the fact that the government won when it did but by the fact that in light of the facts the estate thought it had enough of a chance to win to justify litigation. There must be many more cases in which, the facts being somewhat less convincing, the government either lost entirely or made costly sacrifices.

Legislatures and courts have not yet clearly specified that the real question involved in these cases is whether the tax burden is to be borne by the parties to the transfer (who admittedly got sufficient other benefits from the transfer to warrant their making it because, they claim, there was no tax motive) or by the rest of the taxpaying public. The courts have to some extent but not yet adequately

recognized that the proper economic test of tax liability is the effect or result of the transfer rather than the subjective intent of the person, now dead, who made the transfer. What is more ominous for the public interest is the fact that the courts have quite clearly laid down the rules of the game for all to see and notified the person of wealth just what he must do to escape tax. If he hires good counsel and is reasonably careful, he will have little difficulty setting up the "living" motives which, even if he dies within the presumption period, and quite assuredly if he survives it, will relieve his heirs of tax. What is required of him is neither very difficult nor very obscure.

INCREASING INCENTIVE TO AVOID TAXES

In the past the best protector of the public treasury has been not the provisions of the death tax laws but rather the reluctance of the owner to give away his property. Although persons know, perhaps only vaguely, that the tax at their death could be reduced substantially, they were not able or willing to alienate their accumulations completely. The situation today is different in essentials, the first and most important of which is that the stakes are today much larger and the second of which is that tax avoidance is more widely advertised and practiced on a business basis. Even though the exemptions are generous and some loopholes are not tightly closed, the effective rate of the federal estate tax on even moderate accumulations is much greater than it was ten years ago, and there is little prospect of reduction in the near future. Consequently, the tax items assume a much more prominent position in one's affairs than they did a decade ago. The responsibility for this new situation rests very largely on the federal government rather than on the state governments because the greatest increases in progressive taxes have been made by Washington. While the past indicates that gifts can not be adequately taxed without a gift tax, the past (even if statistical data were available) gives little adequate information on the extent of the need for a gift tax in the future.

In this connection it is important to point out that gifts are made to reduce not only death taxes but also income taxes. In many if not most cases the income tax aspects probably play a larger (or at least as large) part in motivating the donor than do the death tax aspects. The income tax is annual and brought more imminently to the owner's attention and is on him rather than on his heirs. Income tax considerations may be more important than death tax considerations because the federal income tax rates, assuming a 4% yield basis, are higher on accumulations over $1,000,000 than the federal estate tax. By making gifts which split the income so that it goes on to more than one person, the amounts falling in the highest brackets (on which the highest rates apply) is reduced.

This result is to some extent automatically achieved in community property states, and at the option of the parties it can be achieved in other states by making simple transfers or by the use of certain more complicated legal devices, and it can be extended by division among children and other members of the family. There is no reason why the general body of taxpayers who either do not or can not make use of such devices should be forced to carry the burden of government others escape by employing technical devices when there is little essential change in economic conditions. Most of the devices used are not in themselves undesirable economically, and there is no reason for making them prohibitively costly. On the other hand, there is no reason why the pure tax advantages should not be eliminated although, because each case presents peculiar circumstances, no general scheme can be so refined as to put everyone on an exactly equal basis.

THE GIFT TAX AS A PROTECTIVE TAX

The case for a gift tax rests essentially on the functions it can perform in protecting the estate, inheritance, and income taxes. It will directly of itself produce some revenue, but its greatest productivity is the prevention of avoidance of the other taxes. Conceivably it also can remove one of the anomalies of the present income tax, namely that income for which a person works is taxed, but income which he receives as a gift is not taxed. The importance of a gift tax is further emphasized by pointing out that the taxes which it protects ", *i. e.*, makes more effective, are the only progressive personal taxes and the only taxes adjusted, even roughly, to ability to pay. There is no doubt that a system of progressive taxation in a society with our property laws and constitutional restrictions cannot be successful without a gift tax. The steeper the progression and the higher the brackets the greater the necessity for a gift tax.

The Federal Gift Tax

After less than two years' experience with a gift tax in the twenties, a tax which the heads of the treasury opposed and declared unworkable, congress in its general reduction of taxes on the wealthy removed the gift tax and substituted a two-year conclusive presumption of contemplation of death, which was declared unconstitutional in 1932. A few weeks after the court's decision, when the need for revenue seemed pressing, the treasury bowed to necessity, reversed its former position, and proposed a gift tax. The law was passed and went into effect June 6, 1932, and with the exception of changes in rates has been altered very little since then. For a relatively new law it was very well drafted and, although important changes are to be recommended, has on the whole been satisfactory.

The backers and framers of the law seem to have thought of it principally as a protector of the estate tax and took slight account of its relation to the income tax. In general the law provides that transfers by gift (the law does not define "gift") shall be the occasion for a tax to be paid by the donor at rates three-fourths of those of the estate tax after the same specific exemption is given. Gift tax rates and exemptions have been altered when the estate tax was altered. The rates now stand at from 1 and ½% on the first $10,000 to 52 and ½% on all over $50,000,000, after an exemption of $40,000. A further exemption, technically called an exclusion, of $5,000 (after 1938, $4,000) is granted each year to each donor for each donee, *i. e.*, the first $5,000 of any gift, unless of a technical future interest or after 1938 if in a trust, to one donee is not taxed, and there is no limit to the number of exclusions allowed a donor in a single year so that a person with fifteen heirs can give away $75,000 tax free each year. Approximately the same exemptions are granted for gifts to charitable and like institutions as in the estate and income taxes. Generally the same provisions for administration including access to the board of tax appeals are made. There is, however, no exemption for property previously taxed, optional valuation date, eight years for payment of taxes, or state credit. Real estate owned abroad by Americans is taxed by the gift tax but not by the estate tax; the transfer of all government bonds is taxed irrespective of exemption privileges.

The 1924 gift tax taxed not particular transfers but the total of transfers made within the year. The present act goes farther, however, and cumulates all the gifts made since June 6, 1932, to find the bracket and hence the rate applicable to the total made in the current year. The progressive principle is preserved and can not be escaped by spreading gifts over several years to keep all in the low brackets. Thus for gifts made in 1938 the tax is determined by adding the total gifts made since June 6, 1932, deducting the exclusions and exemptions, and computing the tax due on a transfer of this total if made in 1938. Next the total gifts minus exemption (claimed) and exclusions made to the beginning of 1938 is determined and the tax that would be due on this sum if made in 1938 is computed. This total is deducted from the former total giving the tax due on the gift made in 1938. It should be noted that the amount of tax previously paid is not important but rather the amount that would be due on the total of gifts if the present rates were applicable. Thus rates and exemptions can be changed without destroying the cumulation. The amount of tax due on a gift in any year depends in part on the total of gifts made in previous years, because they help determine the bracket into which the gift falls. The tax also depends upon the rates in effect in the year in which the gift is made. The cumulative feature within a year was approved implicitly by the supreme court in *Bromley* v. *McCaughn*

(280 U. S. 124, 1929). The extension beyond one year has not yet been tested, but it is hard to imagine that the court, which has upheld the classifications in the chain store tax cases and in *Maxwell* v. *Bugbee* (250 U. S. 525, 1919) will fail to approve this classification.

FEDERAL TAX INDUCEMENTS FOR MAKING GIFTS

As noted earlier, the gift taxes are three-fourths the estate tax rates. Does this mean that it costs a donor 75% as much to make gifts as to bequeath property? Definitely not! A person trying to make an economical analysis of tax factors affecting the disposition of his property would find many more inducements to making gifts than the 25% difference in rates. These factors include:

1. The double exemption.
2. Multiple exclusions.
3. Avoidance of higher brackets of both the estate and gift tax by making use of lowest brackets of both.
4. No tax on the tax.
5. Saving of income tax.
6. Realization of capital losses before transfer.
7. Saving of state death and income taxes.
8. Exclusion of the credit for gift tax paid on any gifts included in the estate from the corpus of the estate.

On the other hand, tax factors making disposition at death preferable to gifts *inter vivos* include:

1. Postponement of present gift tax for a future estate tax, saving the income that can be earned on the sum paid in gift tax.
2. Avoidance of capital gains tax on increment of gain accrued up to time of the transfer.
3. Absence of federal credit to the state for gift tax paid on gifts included in the estate.
4. Possible income tax costs such as occur
   (a) When the donees' incomes are in higher brackets than the donor's;
   (b) When liquidation of assets to pay tax may produce taxable capital gains.

There are other closely related considerations such as the possibility of choice of time to make a gift to secure a low valuation and the elimination of probate and administration costs. There are, of course, many reasons for making gifts, some of which are much more important than any tax considerations, but adding tax factors to others, that is, treating the tax factors as marginal for purposes of analysis, they are of great and, to a large extent, new importance.

Each individual's case is peculiar, but in almost all cases a very substantial portion of the total tax can be saved by *inter vivos* gifts not of all but of well over half the estate. A person should make gifts to secure the gift tax specific exemption and as many exclusions as possible, but he should not make taxable gifts of property that would qualify for the specific exemption and insurance exemption of the estate tax. The next consideration is so to divide the transfers during life and at death that the maximum advantage is taken of low brackets. Up to a certain point every dollar given during life removes a dollar from the highest estate tax bracket and puts it in a lower gift tax bracket. In computing the effective rate in the brackets, the donor will recall that the gift tax rates are only 75% of the estate tax rates, *i.e.*, that the rate on gifts in the $1,000,000–$1,500,000 bracket is 24% while on estates it is 32%. Only on gifts over $10,000,000 does the rate reach 50%, the rate on estates between $4,000,000 and $4,500,000. He should also note, although the debates do not indicate that congress was aware of the fact, that there is no tax on the sums used to pay the gift tax while there is on the sums used to pay the estate tax. A donor making a gift retains what is necessary to pay the tax, and, since the tax liability is on him (the donor), payment is no gift, and there is no tax due on the amount retained and paid to the government. In contrast the whole estate is taxed, and the tax comes from the estate. When the rates are high, this difference is substantial.

> [A person with $3,000,000 might reason that the tax on a net estate of that amount is $952,000, leaving $2,047,400, but that if he made disposition by gift he could give away about $2,452,000, paying the tax of $547,000 out of what was retained. His heirs would have $400,000 more in the second case than in the first, the difference being due in part to the difference in the rates and in part to the fact that there is no tax on the tax when gifts are made.]

In most cases there will be income tax savings after the gift because the donees will probably have less other income than the donor so that the income falls into lower brackets. The more donees there are, the greater the probability of income tax saving. It may be more accurate to consider the income tax aspects in the light of the total available income after payment of income tax. If a present tax is paid, the group loses permanently the income which the sum used to pay the gift tax would have yielded. Thus, if the tax were $100,000, the donor would lose annually the income this sum yielded minus the income tax on the yield. Some tax counsel attach great, perhaps too great, importance to this loss of yield on the tax, especially for a middle-aged or younger donor.

Consideration of income tax on capital gains may provide one deterrent to *inter vivos* disposition as opposed to testamentary disposition. All capital gains unrealized at the donor's death escape tax while gains on property given during life will be taxed if the donee sells. Even if there is no prospect of the donee needing to sell, the donor might have to liquidate some assets to pay gift tax and be liable for income tax on the gains.

An insufficiently recognized aspect is that if the gift is later taxed as part of the donor's estate, the estate receives credit for the gift tax paid without any addition of this credit as an asset of the estate although it obviously is an asset because it offsets a liability of the estate. On the other hand, if part of the federal estate tax is paid not in cash but by crediting the estate with the gift tax paid on a gift now included in the estate, no credit on the federal tax will be given for any state death tax paid on the gift.

RELATION OF FEDERAL TAX PROVISIONS TO STATE DEATH TAX COLLECTIONS

There are other points that should be taken into consideration by a person desiring to arrange his affairs to reduce his tax, but the most important have been mentioned and indicate that the present relation between the federal gift, estate, and income taxes makes it profitable for persons of some means to pass on to their heirs a large part, but not all, of their estate by gift before death. Without considering income tax aspects (which actually may be more important than transfer tax aspects) it is probably true that, after the lower estates in which the specific exemptions have a larger relative importance, the larger the estate the larger the proportion that should be given away before death. The growing literature on tax avoidance emphasizes that the federal laws clearly establish a system in which *inter vivos* disposition is encouraged although, of course, not to the extent that they would be if there were the present estate tax without a gift tax.

The total of gifts reported for federal tax now run about 20% on the average of the gross amounts left by decedents. The amounts given may seem small compared to the amounts left at death (and they probably indicate the weight of non-tax considerations). It should always be borne in mind, however, that (1) gifts take property from the brackets in which the highest rates would apply, (2) gifts are 30% of net taxable estate, (3) so far as individual action with regard to taxes is concerned the past is a poor index of the future because (a) the sums involved are larger now because tax rates are higher, (b) the high rates seem to be permanent, and (c) tax avoidance is a growing practice and one more widely advertised all the time.

State Gift Taxes

Six states now have gift taxes, Wisconsin, Oregon, Virginia, Colorado, North Carolina, and Minnesota. The last three are about a year old, the first three are six, five, and four years old, respectively. Some were enacted chiefly for the revenue they would produce directly, others more for the revenue they would produce indirctly through protection of the death taxes. They all seem to have been enacted largely as the result of efforts of a small group, frequently almost solely upon the recommendation of some responsible state tax official; none, with the possible exception of Wiscinsin's, has a background of much popular discussion or agitation. Leadership will have to come from a few convinced individuals rather than from any mass demand.

The Dominion of Canada has a gift tax designed solely to protect the income tax, the Dominion having no death tax, although the provincial death taxes will incidentally be strengthened.

The provisions of the estate taxes, of course, vary. All but Wisconsin put the tax on the donor, as does the federal tax, although provision is made for a lien on the property in the hands of the donee if the tax is not paid. Oregon and Minnesota have the cumulative feature, and Wisconsin allows the full exemption only once. Exemptions and rates vary widely. Except in Oregon the tax is progressive not according to the total the donor gives (as in the federal tax) but on the total he gives during each year to each donee. If there are several donees very substantial amounts can thus be transferred by a donor in a single year before the higher brackets are reached. All states exempt gifts to religious and charitable institutions limiting the exemption, however, to institutions within the state. Minnesota exempts gifts to pension and employee benefit funds. Wisconsin, Virginia, Minnesota, and Colorado provide that gift tax paid on gifts included in the estate at death can be credited against the death tax. All provide penalties for failure to obey the terms of the law. There is some variation in the wording of the sections which specify what gifts are brought within the jurisdiction of the tax, but in general the acts try to tax about the same property they would if the donor had died instead; the states set for themselves about the same limits set for them in death taxation by the supreme court.

There have been no final constitutional tests on these taxes, but the supreme court of Wisconsin several years ago upheld the conclusive presumption of contemplation of death on the grounds that it was a gift tax. The constitutionality of a federal gift tax has been upheld, and there seems to be slight possibility that state taxes would not be upheld.

Administration of Gift Taxes

TRANSFERS TO BE INCLUDED

The government should try to include all the purely donative element of transfers without reaching beyond to tax bad bargains and transfers which really discharge an obligation rather than make a gift. Gifts of cash, securities, real estate, life insurance, etc., should, of course, be included. Donative transfers to different forms of joint ownership should also be included even though there may be difficulties of division and valuation in some cases. Thus, though a husband is legally obligated to support his wife and children, he is not legally obligated to make a present gift of capital for the purpose. The Seventh Circuit Court was correct in overruling the district court in the Lilly case on tenancy by the entirety because the donee of a gift in joint or common tenancy or tenancy by the entirety certainly does receive something of value from the transfer just as the donor gives up something. Although dower rights are frequently subject to death tax, property passing in a separation settlement is not taxed under present gift tax laws. The husband in making a settlement is discharging a legal obligation rather than making a gift, and the wife receives (in theory) only what she had before. There are many legal and technical as well as logical problems which the writer is not qualified to discuss, but the preceding statements seem to him roughly correct.

Gifts in kind of valuable property such as jewelry, art objects, autos, furniture, furs, within the family or within the household will present some difficulties, but unless they are out of proportion to the income of the parties they should generally be allowed as maintenance when the legal obligation exists—unless, of course, the gift is a ruse such as appears when the property is reconverted into other forms of property. When there is no legal obligation for support and the total gifts exceed the exemption, most of the present laws tax gifts no matter how small, even the gift of flowers, a book, a cigar whether made at a holiday or incidentally. The apparently absurd results that might occur seem to be exceptional not because parents who make large gifts do not make small ones too but because the latter are not mentioned on the tax return and the authorities do not have sufficient time to make a complete check. The more honest and the better informed taxpayers may be the only ones who pay the full legal tax. To eliminate the problem of these small incidental gifts it might be wise to exempt perhaps ten transfers of $20 or $30 or less a year, the exemption not to apply to gifts over the specified amount in value. Gifts given personally rather than through organized charity for the support or aid of individuals whose need is clear whether or not related to the donor should, within some limits, be exempted from the tax. The specific exemption and exclusion may take care of such cases, but in Wisconsin

some "hard" cases arose when the exemption had been used up in one year and gifts were made later.

Another set of problems arises with trusts. The laws should look to the beneficiaries of the trusts rather than to the trust as a legal entity in order to prevent the use of multiple trusts to secure multiple exemptions and escape progression. The federal law, thanks to a minor change made in 1938, seems fairly well protected against this danger. Income tax aspects present another trust problem. Under present rules it seems possible to make a gift in an irrevocable trust in which the settlor reserves no benefit for himself but retains power of appointment to determine the shares of the beneficiaries; this trust would be taxable as part of his estate, but it would not be taxable as a present gift although he has given away all his interest, and the income would be taxed not to him but to the beneficiaries. He saves income tax without having to pay any gift tax. Is this result desirable or not? Should the gift tax and estate tax be considered *in para materia* without regard to the income tax?

VALUATION

Problems of valuation for gift tax are not peculiar and will not be treated here except to point out: (1) that the increasing reliance placed on actuarial tables, especially when tax rates are high, calls for modernization, and hence the discarding of the century old Actuaries' Combined Experience Table and the almost equally antiquated American Experience Table; (2) that the value of a life insurance policy is not the cash surrender value adjusted for interest, loans, prepaid premiums, and dividends, but is greater because the insured has in addition to his right to cash has a valuable right to insurance protection for which he makes payment and which has value. The rather complicated federal method (computation in practice being done by the insurance company) is the most accurate; it finds the terminal reserve (without reflecting the true value of a policy which can not be replaced because of health, age, occupation, or discontinuance of the type of contract). Division of the corpus of a trust into its separate parts often presents difficulties, but these are not peculiar to a gift tax.

FINDING THE TIME A GIFT WAS MADE

What is often peculiar to a gift tax is the determination of the date when a gift was made. For a death tax this is also often necessary, taking the form generally of deciding whether the gift took effect before or at death. The body of decisions on this question can in many cases be taken over for gift tax purposes but may not always prove satisfactory. Some difficult problems will arise, but they will not be insuperable, and compromise solutions can ordinarily be reached.

JURISDICTION OF THE STATE OVER GIFTS

What is the extent of a state's jurisdiction in taxing gifts? Upon the answer to this undecided question depends much of the success of the states in taxing gifts. There may be considerable question whether state A can tax gifts by its residents of property within the jurisdiction of state B when the laws of B rather than A protect and govern the transfer. The problem has arisen, but so far there seem to be no test cases, probably because the sums involved have not warranted litigation. In some ways the situation will probably remain similar to that of the state death taxes before the supreme court decisions.

One essential difference between death and gift taxes should be kept clearly in mind. That difference stems from the fact that a donor has considerable freedom and option in arranging gifts and selecting particular property for the gift in the light of tax liability; planning for minimum tax at death is more difficult because all, not just part, of the property remaining must pass then, because future tax laws can not be foreseen, because the time of death is uncertain, and because it may be inconvenient to hold property in certain forms or localities indefinitely awaiting death. If a person of weath has property located in different states some of which do not have gift taxes, he can make any gifts he plans from property in the states without tax; it may even pay him to sell property in one place and buy in another to save tax. If some of the donees are in different states or, if rates vary with relationship, differently related, proper selection of property for transfer may reduce the tax. The higher rates, the greater the inducement for utilizing some of these possibilities of reducing taxes. When any type of property as such is exempt and when there is no way of checking free transfer into and out of the property, tax avoidance is made vastly easier. The effects of the exemption of certain types of income from income tax is frequently discussed, but for the wealthy to realize the obvious benefits they must hold their wealth in this form. If, however, the transfer of government bonds, real estate in Canada, silver dollars, real estate in another state, bank deposits, or securities creates no tax liability, it becomes unduly easy for persons of some means to make any transfers that would bear high tax in such property and then, if they wish, induce the donee to convert it into some more desirable form when convenient.

Such avoidance is easier for gift tax than for estate tax simply because it is more convenient for a donor to plan the time of his gift than the time of his death. Among other things the progressive features of the tax is sacrificed. It should be noted that while transfer of real estate abroad (including Canada) is exempt from federal estate tax, it is not exempt from gift tax.

[Conceivably the principle of *Senior* v. *Braden* (295 U. S. 422) might be used to escape tax by converting foreign real estate into trust certificates with all the advantages of personal property and the additional advantage of escape from tax; however, the crucial point in that case seems to have been admitted by the state's attorney before the court and is perhaps not good law.]

Collection of the tax when one of the parties or the property is outside the state is more difficult under a gift tax than under an estate tax because there is no necessity for the property to pass through probate court where the liability can be assessed and collected before the beneficiaries receive title. The state can take legal action against the property of the parties, and under the recent decision in *Milwaukee County* v. *M. E. White Co.* (296 U. S. 268), a state can collect on a judgment for taxes against citizens of other states (at present only if $3,000 or more is involved). But the necessary action is less easy than holding up transfer in probate until tax is paid.

As is well known, the supreme court in a group of decisions rendered less than a decade ago applied the rules that only the state in which the decedent resided could tax his personal property and that real property could be taxed only at its situs. [Exception is made for intangible property having a business situs outside the state.] Presumably the same principles would apply to taxation of gifts. It is interesting however, to note that the court's decisions were rendered not on the basis of inflexible rules of law but on a legal fiction adopted for convenience and to prevent injustice. [See *First National Bank of Boston* v. *Commissioner of Internal Revenue* (Garven Estate), 63 Fed. (2d) 685, 1933, for discussion by the First Circuit Court.] Double taxation as such is not prohibited. Only when the effects of double taxation seem to a majority of the supreme court unjust and inequitable will the powers of the states be limited. The decisions limiting the states have been based upon judicial interpretation of the equal protection and due process clauses of the fourteenth amendment and represent reversal of an earlier position. It is also of interest to note that Justices Holmes, Brandeis, and Stone dissented almost consistently. If, as some observers believe, the philosophy of these three justices is now of greater weight with the court, new decisions arising under state gift taxes might give the states a wider range of authority in taxing transfers of tangible property outside the state of the donor's domicile because of the opportunity of avoidance afforded by the contrary rule. There is some ground for believing that a state could tax as income receipt by a donee of tangible property in another state (*Cohn* v. *Graves*, 300 U. S. 466, 1937). The decision in *Blodgett* v. *Silberman* (277 U. S. 1) that transfer at death of bank notes and coin

in a safe deposit box in another state are not taxable by the state of the decedent's domicile should be watched because of the opportunity offered for escape of state gift tax by gift of such property. A somewhat different decision was reached later in *Baldwin* v. *Missouri* (281 U. S. 586) without any discussion of the former case that lays down the exact line drawn by the court.

It is not impossible and it is certainly to be hoped that until state gift taxes become general and double taxation in this field much more common that states may be able to tax *inter vivos* gifts of property they could not tax at the donor's death. On the other hand, a test case leading to an unfortunate decision may arise any time. In pleading its case before the court, a state should emphasize the necessity of greater power to match the individual's greater ease of adjusting transfers in light of tax aspects during life than at death, as discussed above.

Closely allied with the state's problem of legal jurisdiction to tax gifts is the problem of the state's economic power to tax, *i.e.*, whether a gift tax will induce wealthy individuals to leave the state. The loss of income and eventual death tax from a few individuals might deprive the state of more than the direct and indirect yield of the gift tax. Unfortunately no precise answer can be given.

Only a few members of society have sufficient freedom to decide their residence in light of tax considerations, but the few who can are generally the wealthier ones. Individuals active in business may be relatively tied down, but retired persons typically are freer—and they may often be the ones from whom estate taxes can be expected, unless they give away their property. It is probably correct to say, however, that a person sufficiently tax conscious to determine his residence in light of tax considerations will be sufficiently tax conscious to avoid (some) tax by making *inter vivos* gifts.

The problem depends upon the particular circumstances of each state. New York is probably the hardest case. It is the state from which by far the largest federal gift tax collections have come. It is a state in which a thriving tax avoidance business is conducted. It is a state which depends in part upon progressive state taxes. It is peculiarly fortunate in having taxing jurisdiction over much wealth whose owners live in New York but which is located all over the country. To maintain this advantage it must prevent the owners from moving. Its great metropolitan center is within easy access of two other states in which residence is easily possible so that even people employed in New York City can determine within some limits which state is to have taxing jurisdiction over their property income and their estate at death. Many of its wealthier residents live part of the year in other states and could without much difficulty change their legal residence.

Illinois, Ohio, North Carolina, Massachusetts, and Washington, for example, present quite different pictures in which the danger of shifting residence to avoid tax would seem less ominous. For Florida and California the problem might be to avoid setting up tax differentials that would discourage newcomers from setting up residence.

As mentioned earlier, the individual might make his gifts of property in another state, in which case his home state might not suffer because the gift removed no property from the estate it could tax at his death. By inducing him to make gifts of property outside the stae law might result in his leaving more of his estate within the state until his death.

From what the writer has been able to learn of the experience in the states with gift taxes, the evidence of shifting residence to avoid tax has not appeared, but he would not assert that such shifting would never occur. The gift tax might well be the additional factor, which, coming after the others, would induce taxpayers to move. But it is only fair to point out that generally the persons to whom the gift tax is important enough to influence their choice of residence must be persons who are expecting to make gifts. If the state had had no gift tax, such persons would stay but would make gifts which cost the state about as much as their leaving the state. The issue is, then, not whether the state is out in one case and not in another, but rather how much more it is out in the worst case. How much is it worth a state to provide a tax loophole to keep tax-avoiders from leaving? The answer may well depend upon how much income tax the state collects from individuals free enough to move.

The situation of each state presents peculiar conditions determined by the type of the economy, the concentration of ownership, the ties of the wealthy to business and professions, the proximity of satisfactory residential regions in other states, the rest of the tax structure, and so forth. But all probably have this in common, that they are limited to some extent by the existence of states that will not have the tax.

The writer's feeling is that almost all states would profit from having a state gift tax with moderate rates, but he wishes to emphasize again that the problem of tax avoidance by making gifts is one created very largely by federal tax laws which leaves the states as innocent sufferers unable adequately to protect their own fiscal interests.

SOURCES OF INFORMATION

Secretary of the Treasury Mellon repeatedly declared that a gift tax could not be administered. Experience of the last few years indicates that he was underestimating the ability of the civil servant and that the tax is not unduly difficult to collect. To a large extent

it depends upon cooperation of the taxpayer, but such cooperation will in most cases be given if the attitude of the officials is fair and the rationale of the tax evident.

Whether the tax is on the donor or on the donee, both should be required to file returns. The best procedure seems to be to require every person filing an income tax return to state whether or not he made or received any gifts during the year. All trustees should be required to file information returns. Concealment of any but small gifts is seldom to the taxpayer's (or his heir's) interest simply because of the possibility of discovery later, especially at death, when a staggering amount of accrued interest may be due. There will be some failure to report because the parties are unfamiliar with the tax or because they are outside the jurisdiction (and do not file income tax returns). As mentioned earlier, small gifts are frequently liable to tax because larger gifts use up the exemption, but they are quite commonly overlooked — at least a study of over three thousand state tax returns indicates that few small gifts are reported even though the family relations were probably good enough to lead one to expect exchange of Christmas presents. Published Securities Exchange Commission data on stock transfers by officers and large holders will indicate which transfers were by gift. Insurance companies can be required to report irrevocable changes of beneficiaries and some other indications of gift. Real estate transfers can often be checked for information. Changes in the parties' incomes from investments may be noted in auditing income tax returns. Possible information returns could be required from dealers in autos, jewelry, and other articles of large value. Corporations doing business in the state might be required to report changes in security holdings over a certain amount. Thus, there are numerous sources of information available for the government.

Who should be watched as potential donors and donees? By and to whom are most gifts made? Out of 3001 Wisconsin cases including all reported gifts, whether taxable or not, in the Madison, Milwaukee, and Racine collection districts through 1936 the relationship of the donees to the donors was as follows:

Children	1964	Brother, sister	109
Spouse	327	Parent	36
Grandchildren	258	Aunt, uncle	19
Nephew, niece, cousin	145	Non-relative	143

The main problem of administration is provision of adequate staff to utilize and check various sources. The ordinary procedure is for the legislature to enact the tax but vote little or no allowance for its enforcement, thus adding the burden to that of some other official, usually the person handling the estate tax (in Wisconsin it is handled by the local income tax assessor). Although no official

may be able to take on some more work without his previous duties suffering too seriously, there is little doubt that if a state gift tax is to be administered thoroughly some extra staff will be required unless the tax is so linked with the federal tax that the state can leave most of the work to the federal agents. The amount of effort required, however, is much less than the amount taken for the death tax, at least in the cases with which the writer is familiar.

One state is in the process of checking real estate transfers for possible taxable gifts. So far the additional tax disclosed is considerably more than enough to pay for the check of the whole state and only a part of the total has as yet been covered.

Although the federal administration is apparently good, it is not perfect, and a good many transfers probably escape investigation either through ignorance of the act, especially in cases of transfer to joint ownership or when the amounts are small, but the exclusions and exemptions are so high that federal revenue probably suffers little from failure of administration. If the exemption and exclusion are reduced, as seems desirable, some additional staff would be necessary for reasonably thorough investigation. Federal standards of valuation are probably higher than those of the states.

At present the amount of aid available to state tax administrators from federal gift tax agents depends very largely upon the relationship in individual cases. In some states there is apparently no exchange of information while in at least one other there is commendable cooperation. The legal situation is as yet not clear, but the treasury could, it seems, grant state officials the same access granted for income tax. A state can, and probably should, require its residents to disclose all information about the federal tax, as Virginia does, and get the data indirectly.

The cumulative feature seems to have produced little if any difficulty of administration. One year's tax can not be settled until the amount of gifts in all previous years is definitely determined, and when administration is delayed, as it will be at times, especially when there is litigation, some uncertainty and inconvenience will result and, if the interest rate on deficiencies is high, some injustice at times. How frequent such cases are no one outside the bureau could say, but in many conferences with tax attorneys and trust officers I have heard no complaints and feel sure that compared with the benefits from cumulation this disadvantage is negligible.

Relations Between Federal and State Gift Taxes

Time limitations prevent full discussion of federal-state death and gift tax relations, but it is certainly proper to recall the repeated expressions of concern over the problem of the states from persons in high places who seem so far to have done little to implement their words. The gift tax offers peculiar opportunities for some experimentation in sharing or further use of the credit; it is closely

associated with the estate tax in which crediting has been successfully applied; it is a new tax for which there was originally no (and still very little) vested state interest in administrative positions; the sums involved are not large enough to wreck a plan because of necessary difficulties of apportioning the money to go back to the states; even more than a death tax, a gift tax is one which no one state can effectively use to protect its own interests fully if other states fail to cooperate; in general only a few taxpayers need be reached and they are relatively well to do and, with their counsel, well informed and capable of meeting any reasonable burden of compliance placed on them. If there is ever a possibility of coordination it might be wise for the federal government to take over state employees to secure their knowledge of local conditions and eliminate any of their objections to the program.

> [The undersecretary of the treasury, answering the statement of the governor of New York before the senate committee last spring, pointed out that the interest of the states were better served since the federal gift tax than they would have been without it. This is true, but he failed to point out that the more significant point is how the federal estate-income-gift tax situation affects the states. Given the present income and estate taxes without a gift tax, the states would be worse off than they now are as a result of federal policy, but so long as the federal government grants substantial tax concessions to gifts, it encourages giving and cuts the death tax base out from under the states. To answer that things could be worse is not to demonstrate that they are fair. Although it is true that the federal estate and income taxes make concessions to the states, such as the 80% credit, leaving small incomes and estates to the states and allowing deduction of state income and other taxes before computing federal income tax base, these concessions are strictly limited in practice because the competition of states makes what is legally possible, economically impossible. No one state could effectively set up death, income, and gift tax differentials that would cause serious damage to Washington. States can go a certain distance in enacting protective gift taxes, and they probably should, but they are necessarily limited in fully protecting their own interests.]

It is hard to know just what would be the best solution of the problem of federal and state relations, especially when the future federal tax structure is uncertain. Important changes that might be made in the federal structure, such as consolidation of the estate and gift tax into one tax, would require some revamping of the crediting device and might be a strategic occasion for extending the credit to the gift tax. For reasons of economy in administrative costs one federal law supplanting various state laws would

seem best. How then should the funds be apportioned? Some states now collect as much or more under their own gift taxes than Washington does in their state under its gift tax, and they would probably object to sharing on less than a 50% basis. Others collect nothing and might be willing to accept a small share. A crediting device would seem to require enactment of new state laws and at least some state administrative cost; it would probably be more expensive than simple sharing but would have the advantage of being similar to the present death tax credit. Many states have lower death tax exemptions than Washington and might want to tax smaller gifts than Washington seems apt to tax for some time to come, so that states should be left some freedom to adjust their policies within the lower range, as now provided in the death tax field. The solution of this problem rests more with Washington than with the states although the latter might exert some unified pressure on their congressmen to assure consideration sympathetic to their interests.

Changes to be Recommended

Many changes of different relative importance in the present federal and state gift taxes could be recommended. Probably the most important and fundamental would be the coordination of the gift and estate taxes into a single transfer tax. Highly to be desired as such a program is, it is one that depends upon federal rather than state action, because it is hardly conceivable that a state could successfully administer such a tax without federal leadership. It might also be wise to consider taxing gifts and perhaps inheritances as income, as suggested by Prof. Simons; there is much to be said for such a program, but the writer feels that there is slight probability of any state embarking on it, at least without federal leadership, which to date does not seem forthcoming. There does not seem to be much logic in exempting gifts from income tax, and it might be that some states would like to try to meet the problem of gifts by taxing them as part of the donee's income. (Few states have income tax rates high enough to warrant or necessitate use of any complicated averaging devices.)

The writer has elsewhere raised the problem of avoidance of death and gift taxes by the use of long-term trusts. Briefly, the avoidance is secured by making a trust giving two or more successive generations the income for life, title remaining with the trustee. The laws against perpetuities set some limits on the number of generations which can escape tax, but the limits are wide enough to permit substantial tax savings. Closely allied is the avoidance possible by careful use of powers of appointment. The states as well as the federal government should undoubtedly take all the measures they can to prevent further avoidance and reach as much

as possible of property already so tied up; it might be wise to see whether the court as now constituted would reverse the decisions in the Coolidge cases and give the governments the powers which the four dissenting justices declared they had.

The total of the present federal gift and estate tax exemptions and exclusions seems very high. Unfortunately the recent attempt to reduce the total by $40,000 failed for reasons not clear to the writer. In some cases the states may have erred by making the exemptions too low rather than too high, but in most cases this does not seem to be true. With few exceptions, the effective state gift tax rates are not very high, especially in the states which do not have the cumulative feature.

Most states which have not yet enacted a gift tax would probably profit from doing so. Where tried it has not proved difficult to administer, and aid from the federal agents will probably be available in the future. Conceivably a few states might lose more than they would gain, but the writer suspects that the fears are exaggerated in most cases. Probably no state could enact rates high enough to eliminate completely the differentials favoring gifts set up by the federal laws, but some protective steps would be better than nothing at all. Changes may be made in the federal law which would better protect the states and provide them some share, but till the statute is in force the states will have to protect their own interests as well as they can.

One further suggestion can be made. Over $2,000,000,000 of gifts have been reported for federal gift tax since June 6, 1932. There is high probability that most of this has or will permanently escape state death tax. It is obvious that these gifts will reduce the highest brackets so that the proportion of total revenue lost will be much greater than the proportion of total assets passing included in the estate. One hope, and probably the only one, for the states is tightening of the contemplation of death and transfers to take effect at death provisions of the state death taxes. This can be done to some extent in some states by stricter administration, but more will probably depend upon the legislatures and the courts.

The legislatures can make use of the statutory presumption by lengthening the period; a three- or four-year period might be the longest to which the courts would attach significant importance, but attempts should be made to make the most of the presumption period. Experimentation with other types of presumption could be tried, such as presumptions that gifts made after the decedent was over 65, 70, or 75, were in contemplation of death, or gifts made after the federal gift tax was enacted. Legislatures might presume that certain alleged motives for making a transfer would not disprove contemplation of death, such motives as gifts to reduce income tax, or provide for children with $5,000 or more income, or gifts which are part of a general program. The strict wording of the

California and some other laws might be inserted, and the New Mexico device of higher rate on *inter vivos* gifts could be applied. In the light of decisions that have and have not been made interpreting transfers to take effect at death each state should insert into the law the strictest possible constitutional provisions taxing trusts and transfers from one generation to another. The prospects of the states' collecting much of the tax which would reasonably be due on these past transfers are discouraging but not hopeless. In any case steps should be taken to profit from the lessons of the past.

CHAIRMAN MCPHERSON: That was certainly a fine talk.

Now we will listen to Mr. Morrissett, the state tax commissioner of Virginia, on "The Effects of the Federal Estate Tax Credit on State Finances."

THE EFFECTS OF THE FEDERAL ESTATE TAX CREDIT ON STATE FINANCES

C. H. MORRISSETT
State Tax Commissioner, Virginia

The act of congress, approved February 26, 1926, known as the revenue act of 1926, allows a certain credit on account of estate, inheritance, legacy or succession taxes actually paid to any state or territory or the District of Columbia in respect of any property included in the gross estate. The maximum credit so allowed an estate is 80% of the estate tax imposed by that act of congress. The tax rates contained in that act are graduated to 20%.

This is the existing federal estate tax credit. The present assignment imposes on me the duty of briefly stating its effects on state finances. For there is no other federal estate tax credit within the meaning of that term as we are now using it.

The revenue act of 1932, by section 401 (b) thereof, as amended by section 201 of the revenue act of 1935, imposes a supplemental tax in addition to the tax imposed by the revenue act of 1926, but unfortunately for states and estates, section 402(a) of the revenue act of 1932 provides that the 80% credit shall not be allowed with respect to this additional tax. The abandonment of the 80% credit as to the additional tax, the rates of which are graduated to 70%, was due to the desire of congress to make the 1932 act as productive of federal revenue as possible. This action, while prompted by genuine need, constituted on principle a backward step, and in fact seriously impaired the good results of the constructive step which had been taken in 1926.

The 80% credit provision of the revenue act of 1926, which is still alive as to estates, was enacted by congress following the report of the National Committee on Inheritance Taxation to the National

Conference on Estate and Inheritance Taxation held at New Orleans, Louisiana, November 10, 1925, under the auspices of the National Tax Association. That able committee, of which Mr. Frederic A. Delano was chairman, and Mr. J. Vaughan Gary was executive secretary, acquitted itself well and performed great service.

One very desirable effect of this 80% credit provision of the revenue act of 1926 was to abolish "havens of refuge from inheritance taxes." Moreover, it induced certain states not having state inheritance tax laws to enact them. When a state takes full advantage of the federal credit, the total amount of death taxes, state and federal, is not thereby increased, and the taking of such full advantage is not detrimental to the estates of decedents.

The effects of the federal estate tax credit on state finances have been constructive. From 1926 to 1932, this use of the credit device was an excellent example of what can be accomplished in the realm of overlapping taxation in this country by cooperation between the federal government on the one hand and the state governments on the other.

The federal estate tax credit has substantially increased state revenues from death taxes. An attempt was recently made to obtain from the forty-seven states having state inheritance or estate taxes figures showing the total amount of inheritance, estate or death taxes collected by each state in each of the three last preceding fiscal years and the amount collected by each state in each such year attributable to the 80% credit provision of the revenue act of 1926 and which would not have been collected except for such provision. Replies were received from almost all the states. Some of these replies may be subject to misinterpretation, and for this reason it is not thought desirable to tabulate them here. Moreover, some of the states were unable with the figures and data at hand to state the amounts attributable to the 80% credit provision. But it may be emphasized that the total revenue which the states are raising by means of inheritance or estate taxes is considerably more than one hundred million dollars annually and that the revenue attributable to the 80% credit provision is substantial and must be spoken of in terms of millions, possibly as much as 10% of the total.

Since 1932 there have been two federal estate taxes—the tax of 1926, and the additional tax of 1932 as affected by the 1934 and 1935 legislation. This situation prompted a movement in the seventy-fifth congress, third session, to eliminate the dual rate schedule by substituting one rate schedule; or to express it differently, to enact one federal estate tax to take the place of the existing two. This was altogether fitting and proper in the interest of simplification; but it was proposed to allow a credit for state death taxes of only 16½%. This credit was claimed by its sponsors to be approximately equal *on an average* to the 80% credit based on the 1926

rates. This means that it was based on the aggregate of all the states thrown together, and certain states produced evidence before the committee on finance of the United States Senate in March, 1938, that if the 16½% proposal was adopted, the revenue of those and various other states would be seriously affected, and that the suggested credit was too small to save them harmless. The result was that the revenue act of 1938 made no changes in these respects.

The question of an equitable division is an open one. It may be conceded that we are not living under the conditions of 1926. Convincing arguments have been made that, as the devolution of estates occurs under state laws and not under acts of congress, and as congress is comparatively a newcomer in the field of estate taxation, the right of the states to tax the devolution of estates is logically superior to the right of congress. Probably no reasonable man will seriously contend on principle that congress has the superior right. Legally the rights are equal. This may suggest an acceptable division. A federal estate tax credit of fifty per cent under a consolidated federal estate tax was contended for by several state tax commissioners who appeared at the hearings before the committee on finance of the United States Senate on the revenue bill of 1938 in March, 1938, and they were supported by a notable letter from Governor Herbert H. Lehman of New York to the chairman of the committee.

Chairman McPherson: The next speaker is Mr. Farwell Knapp, attorney-at-law, Connecticut, and chairman of the committee of the National Tax Association on double domicile in inheritance taxation.

Mr. Knapp: Mr. Chairman, Ladies and Gentlemen: I can scarcely refrain from commenting on the two papers which have preceded mine, but since I am going to take up so much of your time on domicile, I think perhaps I had better stick to that.

In view of the limitations of time prescribed by the rules, I shall have to cut this report materially. I hope that the chairman will keep time and warn me before my time is up.

FOURTH REPORT OF THE COMMITTEE OF THE NATIONAL TAX ASSOCIATION ON DOUBLE DOMICILE IN INHERITANCE TAXATION

FARWELL KNAPP, CHAIRMAN

In the third report of this committee, presented at the Baltimore conference in 1937, it was remarked that then pending litigation—among other things—prevented the committee from attempting to arrive at any final conclusions as to its central problem. Since that time the Hunt case has been decided by the supreme court, but the

Green case remains undecided. Whether the decision in the Green case, when it is handed down, will contain anything particularly helpful toward the solution of the problem of double domicile in inheritance taxation is a pure speculation; but there is no doubt that the Hunt decision is important for our purposes, and must furnish the basis for any future discussion. Considerable attention will therefore be given in this report to an analysis of that case. Thereafter we shall discuss certain proposed solutions to our problem; but it should be understood that this committee is not yet in a position to recommend any one solution, and that the discussion herein of certain proposed solutions represents the views of various members of the committee, and is not to be taken as necessarily representing their unanimous opinion.

The Hunt Case

The Hunt Case was decided December 6, 1937, under the name of *Worcester County Trust Company* v. *Riley, et al.*, 82 L. Ed. 192 (Advance Sheet No. 5). It will be recalled that this was a suit under the Federal Interpleader Act, wherein an executor impleaded the death tax officials of Massachusetts and California, in a suit brought in the federal district court for the District of Massachusetts. The two sets of taxing authorities were each claiming that decedent was domiciled at his death within their respective states. While the death taxes of either state had not as yet been finally determined, an estimate indicated that they were both substantial, and would differ by a few thousand dollars. The executor offered to pay the larger amount of estimated tax into court, or to put up a bond therefor; asserted that it was impossible in law or in fact for decedent to be domiciled in two places at once; asked the court to determine where decedent's domicile was, and to enjoin the taxing officials of whichever state turned out not to be the domicile from attempting to assess any death tax with respect to intangibles.

The California tax officials appeared specially in the federal district court and moved to dismiss the complaint upon the ground that the suit was brought against them in their official capacity, and was in substance a suit against the state forbidden by the eleventh amendment. The district court overruled this contention and granted a temporary injunction. This was reversed by the Circuit Court of Appeals, 89 F (2nd) 59, which latter decision was affirmed by the United States Supreme Court.

The argument of the executor was that as the officers of each state assert the right to collect the tax out of decedent's property within the state, they may succeed in establishing that right by a determination in the courts of each state that decedent was last domiciled in each state (as happened in the Dorrance case); that neither state could constitutionally authorize its officials to impose the tax if decedent was last domiciled elsewhere; that the estate is

thus exposed to the danger of double taxation of intangibles, which the constitution forbids (*First National Bank* v. *Maine*). The executor insisted that the suit was not brought against the states in violation of the eleventh amendment, but merely to enjoin threatened unconstitutional acts of state officials. There is plenty of precedent for enjoining such acts.

The supreme court rejected this argument. It said:

> "Petitioner's real concern is that the judgment of the California court, if it should decide that decedent was domiciled there, may be erroneous or may conflict with that of the Massachusetts courts. But conflicting decisions upon the same issue of fact do not necessarily connote erroneous judicial action. Differences in proof and the latitude necessarily allowed to the trier of fact in each case to weigh and draw inferences from evidence and to pass upon the credibility of witnesses, might lead an appellate court to conclude that in none is the judgment erroneous. In any case the constitution of the United States does not guarantee that the decision of state courts shall be free from error . . . or require that pronouncements shall be consistent. . . . Neither the fourteenth amendment nor the full faith and credit clause requires uniformity in the decisions of the courts of different states as to the place of domicil, where the exertion of state power is dependent upon domicil within its boundaries. . . . Hence it cannot be said that the threatened action of respondents (the California tax officials) involves any breach of state law or Constitution of the United States. Since the proposed action is the performance of a duty imposed by the statute of the state upon state officials through whom alone the state can act, restraint of their action, which the bill of complaint prays, is restraint of state action, and the suit is in substance one against the state which the eleventh amendment forbids. . . ."

Time does not permit extended comment on this decision. At any rate, it definitely lays down the rule that the Federal Interpleader Act cannot be used to settle a double domicile case if either claiming state objects. The case does not decide what would happen if neither state objected.

In the Dorrance case the supreme court never explained why it decided as it did; but now in the Hunt case the probable reason appears, namely that the constitution does not guarantee that the courts of two states shall reach the same result upon the same set of facts. No doubt this might seem peculiar to a foreigner or to a layman who has not in mind the structure of the government of this country, but no one will be surprised who realizes the important part played by the quasi-sovereign states in our form of federal

government. While it is true that the United States Supreme Court is the final arbiter of what is and what is not constitutional, and the state courts must conform, yet outside of that field the state courts have the final word. It is therefore not strange that one state may differ in its laws from another, whether those laws are statutory or judge-made; and by the same token, given a set of facts, the court of one state is not bound to draw the same conclusion therefrom as did the court of another state. If this were not so, state sovereignty would be gravely impaired, for the states would have no effective authority to determine what their own laws should be. And the matter of domicile is perhaps peculiarly involved in sovereignty; for one of the basic attributes of a sovereign is the power to determine who shall and who shall not be its citizens—and citizenship usually depends upon domicile.

It was probably considerations such as these which led to the decision in the Hunt case; and however much one may regret that the promise of a solution to the double domicile problem was blighted, one must admit that there are sound reasons underlying the decision.

We shall not remark further upon the Green case; we have already discussed it in prior reports. At the present writing, briefs are being filed with the master appointed by the supreme court.

Discussion of Compacts or Reciprocal Legislation between the States Creating Non-Judicial Boards to Decide Disputes Involving Multiple Claims of Domicile.

In its third report the committee discussed interstate compacts, and after the presentation of the report at the Baltimore conference, a round-table discussion was had upon the alternative solution of reciprocal legislation between the states, and a draft of such a proposed reciprocal law was subjected to criticism. Both of these plans envisaged the creation of non-judicial boards to determine the domicile of a decedent when disputed.

The compact plan would have required the advance consent of congress, which could probably have been obtained; but the disadvantage was that interstate compacts are rigid things, alterable only with difficulty. This disadvantage was so serious, in the view of the committee, as to lead to the conclusion that the compact plan should be abandoned as a solution.

The other similar plan, that of reciprocal legislation, was given rather more attention by the committee. Under this plan, if states X and Y each claimed that a decedent died domiciled within their respective borders, and if no agreement proved possible within a certain limited time, a three-member board of arbitration was to be chosen by authorities in three neutral states (which latter states would have to be in the reciprocal group). This board would hear evidence in both contesting states or at some midway point, as con-

venience might determine; it would decide where decedent's domicile was. Meanwhile all litigation on the matter of decedent's domicile would be forbidden in any court of either contesting state. The board's decision would be final. It was proposed that a new board be set up to try each case, rather than to attempt to arrange for a permanent board.

Such a board would not, of course, be a court; there is no known method, under our federal system of government, for creating a court by state law which shall have jurisdiction over two or more states. The theory was, in this plan, to treat the states as quasi-independent sovereigns who might, by treaty with one another, arrange for the arbitration of certain disputed claims.

While such a plan might look well in theory, it was found by the committee that various practical objections to it arose, which led the committee to abandon the plan as a workable solution, at least for the present and until some way had been found to remove the force of the objections. There were two main objections.

First: Lawyers feel strongly that a domicile case should be tried before a regular court with known rules of evidence, with a right of appeal to a higher court if necessary. Any domicile case ordinarily involves the presentation of a great mass of facts. It is often necessary to go in some detail into the whole life-history of the decedent, his family, social, and business relations, and so on. Just as many questions of the admissibility of evidence may arise in a domicile case as in any other case. The authority who rules upon the admissibility should be a judge skilled in such matters; the members of such a board would almost certainly not be judges, although they might or might not be lawyers. Moreover, an appeal should be permitted to a higher court if the trial tribunal makes erroneous rulings either as to the admissibility of evidence or as to other rules of law (compare the rights of appeal to federal courts from rulings of federal administrative boards). But it seems impossible to provide for an appeal from the rulings of such a board of arbitration to any known court. The federal courts are certainly not open to such appeals (unless congress radically changed the judiciary act); and almost equally certainly the courts of either of the contesting states ought not to be open to such appeals, since the main reason for creating such board would be to avoid the effects of any prejudice which might exist if the case were tried in the courts of either of the contesting states; and as for the possibility of allowing an appeal to the courts of a neutral (reciprocal) state, it is not easy to see how so novel and untraditional an idea could be put across.

Second: It is obvious that the members of such board of arbitration must be adequately compensated for their time devoted to the hearing and consideration of a case of disputed domicile (which time might be considerable), as well as reimbursed for their travel-

ing and living expenses during such time; for otherwise high-grade men could not be secured. It is anticipated that grave difficulties would be presented if it were attempted to have an appropriation for such purposes passed by almost any state legislature; the amount could never be accurately forecast, and legislatures of most states are reluctant to vote contingent funds to the executive department. So that it seems likely that any remuneration received by members of the board would have to come out of the funds of the estate. This is not unfair, for the estate would profit by the existence of the board, since the estate thereby escapes the possibility of double death taxes. But an element of bargaining would be unavoidably introduced which might well turn out to be objectionable, for the executors will seldom be really neutral in double domicile disputes; the amount of death tax claimed by one state will seldom be exactly the same as that claimed by the other state (unless the estate is very large, in which case any differences in state death taxes tend to be ironed out by the 80% credit provision of the 1926 Federal Estate Tax Act); and it is not unlikely that questions of descent, construction of wills, administrative rules, and other matters quite apart from death taxes will be at least indirectly involved in the determination of decedent's domicile; so that the executors, if they are faithful to their trust, cannot be neutral as to where decedent's last domicile was. But to have the members of the board rely, for their remuneration, upon unneutral executors is obviously inadvisable.

Moreover, a place on the board, under any such arrangement, might well turn out to be a juicy plum in a case where a large amount was at stake; and as soon as that was discovered by the politicians they would wreck the efficiency of the board by seeing that they themselves get places on it.

A temporary board of arbitration therefore seems impracticable; and a permanent salaried board seems almost equally so, although for different reasons. It would be clumsy and expensive; it would have to be something like the World Court backed by the League of Nations; its financial support would present constant difficulties in the legislatures of all states which took part in any such plan—which means, ideally, all 48 legislatures plus congress as the legislature of the District of Columbia plus the legislatures of our territories and possessions. It is believed that most state legislators are, and will remain, profoundly uninterested in problems of executors in connection with double death taxes.

Your committee is forced to the conclusion that only a salaried judge, holding a regular court, with the ordinary rights of appeal therefrom, can adequately solve the difficulties inherent in a double domicile case. Judges of courts of either contesting state may be unconsciously prejudiced, however fair they may try to be; judges of courts of neutral states are not available under our system of

jurisprudence; but the judges of the United States district courts are less likely to be influenced by prejudice. It would seem both necessary and desirable that they have their part in whatever solution to this problem may be found; but a grave question remains as to whether such federal judges, even if they were willing to assist, have power to do so under the constitution and the judiciary act. To this question your committee will address itself in another part of this report; but, before doing so, we shall comment upon certain other proposed solutions, in order to clear the field.

Discussion of Proposed Solution of Double Suits in Federal Courts

Although the result of the Hunt case forbids a single suit by an executor in a federal court on the basis of the Federal Interpleader Act, the decision does not, of course, go farther than its facts, and does not purport to forbid all suits in federal district courts in an endeavor to solve our problem. Accordingly it has been suggested that the following procedure might be successful: given a case in which states A and B were each claiming the domicile of a decedent, let the executor sue the taxing officials of state A in the federal district court in state A, alleging that decedent died domiciled in state B, and asking for a declaratory judgment as to decedent's domicile, and let the executor simultaneously bring another suit against the taxing officials of state B in the federal district court in state B, this time alleging that decedent died domiciled in state A, and likewise asking for a declaratory judgment as to domicile. Or, to put it more exactly, in each suit the executor shall allege that it would be unconstitutional for defendants to levy a death tax with respect to decedent's intangible personalty because decedent's domicile was elsewhere. As a part of this plan, both of the federal courts would be simultaneously notified of the pendency of the action in the other court, and the executor would, moreover, stipulate the court in which he intends first to prosecute the case to judgment. The first decision obtained will be pleaded in the other district court. If the district courts differ and are in the same circuit, the circuit court of appeals will decide which was right; if the district courts differ but are in different circuits, then the supreme court will ultimately decide the case, unless the circuit courts of appeal agree.

The purpose of this procedure is to submit the question of domicile to one rather than two systems of courts and thus impose upon the tribunal of last resort where the conflicting decisions, if any, converge the duty of deciding which of its inferior courts was right. This will forestall the application of the rule emphasized in the Hunt case that no federal question is involved if two state courts reach opposite conclusions as to a decedent's domicile.

A majority of your committee cannot agree that this plan is feasible. A minor difficulty is that the executor must act very promptly; in order to be safe he should start his actions in the two district courts before there has been a finding of domicile in any state court. But numerous states require that a finding of domicile must be made by the probate court before an executor can qualify therein. However, it may be that an executor could obviate this difficulty by promptly appealing, to an upper state court, the preliminary finding of domicile made by the probate court, and by trying to delay the argument of that appeal until the federal courts have had their say. Yet this may be impracticable for a variety of reasons which will be readily apparent and so need not be detailed here; moreover it is extremely doubtful whether the federal courts would have power to stay proceedings in the state courts, or whether the state courts need pay any attention to the decision of the federal courts upon the matter in question, whether the final decision be made by the district courts or by the United States Supreme Court itself; yet if the answer to these two questions is in the negative, there is nothing to prevent one or both state courts from deciding the matter adversely to the executor, whatever the result in the federal courts may be.

Another technical objection is that since the parties in the two federal suits must necessarily be different, the decision in one suit could not be pleaded in the other, but both must go to judgment. This would avoid any adverse comment on the part of either federal judge that the executor had taken inconsistent positions as to decedent's domicile in the two federal suits; but it would prolong proceedings.

The most weighty objection, if valid, would seem to be that such double suits in federal court are quite as much suits against the states themselves, and hence forbidden by the eleventh amendment, as was the action in the Hunt case. To a majority of your committee, the two situations seem indistinguishable on this point.

Discussion of Compromises as a Practicable Solution

At the present time the taxing authorities of some states have a rather informal practice of compromising double domicile cases—or at least some of them—if the other claiming state will do likewise. This result is usually most desirable from the point of view of the executor, since it avoids expensive litigation, and results in the estate's paying an amount which approximately equals one death tax. As an example, take a case where a close question exists as to whether a decedent was domiciled at death in state A or in state B. The taxing authorities of both states, being fully advised of the facts, are honestly in doubt. They, as well as the executor, desire to avoid long and expensive litigation which will establish no great

principle of law, but will only decide the particular case on its facts. Perhaps no great amount of money is involved which would call for extra exertions on the part of either set of taxing officials. Suppose that, if decedent turned out to be domiciled in state A, state A's death tax would be $60,000 and state B's nothing; whereas if state B turned out to be the domicile, state B's death tax would be $40,000 and state A's nothing. If, then, the executor can persuade both sets of taxing officials to compromise their respective claims for one-half thereof, the result will be that the matter will be settled out of court by the executor's paying to state A $30,000 and to state B $20,000, or a total of $50,000.

While this method may have many good aspects, in that it accomplishes an approximately just result from the point of view of the executor, with the minimum of delay and litigation, yet it may be argued that it does less than justice to one of the states concerned, and more than justice to the other; for by hypothesis one of the two states is entitled to all the tax and the other to none. But most compromises involve similar considerations, and are not to be condemned thereby.

Many taxing officials, however, feel that they are not now authorized, by the laws under which they operate, to enter into such compromises; and they question the possibility of persuading their legislatures to grant such authority, even if it would be wise for the taxing officials to exercise it in certain cases. It is true that under the laws of many, if not of most, states taxing officials are ordinarily given some leeway in compromising obscure tax question, or at least in agreeing tentatively to a compromise which is approved by the governor or by some official body; but such authority is ordinarily exercised in cases where the law is doubtful rather than in cases where the facts are doubtful. Domicile cases are chiefly of the latter class. It is the general position of the legal adviser to the state taxing official (such legal adviser being usually the attorney general) to press the state's claim in cases where the facts are doubtful, or where the state's claim depends on mixed questions of fact and law.

But even if all state legislatures could be persuaded to grant to their taxing officials powers to compromise questions of fact—and there is grave doubt whether legislatures could be induced to do this—yet the human element would enter. The majority of your committee feel skeptical as to the human element, and are consequently led to reject this proposed solution by compromise as generally not feasible, although agreeing that in some cases it may be possible. In the case of a very large estate, where a vast sum of death taxes is involved, the pressure upon a state taxing official may be very great; all sorts of political pulling and hauling may occur; the newspapers may give the matter much publicity; and a

state official, however honest, would be unwilling to compromise such a matter because of the almost inevitable political repercussions.

Moreover, this solution by compromise is based upon the fact that mutual confidence exists between the executor and the taxing officials of the two states. It will not work if mutual confidence is absent. But how are the taxing officials of either state to be sure that all the cards as to domicile are on the table? Sometimes an investigation is not as effective as cross-examination in bringing all hidden facts to light.

So it seems that compromise will not work in all cases; and the committee therefore cannot adopt it as a practical general solution to our problem, though we recognize that it may be used in certain cases as a simple and expeditious method of settling an extremely difficult question.

Discussion of Proposed Solution Flowing from the Green Case

It will be recalled that the Green case involved the claims of four states to death taxes from the estate of Edward H. R. Green. These tax claims totalled more than the estate. An original bill was brought by Texas in the United States Supreme Court, in which the other three states and the widow and sister of decedent were defendants. It was requested that the supreme court determine the domicile. The supreme court took the case, one of the justices (now no longer on the bench) remarking that a real controversy between the states existed—on which ground alone would an original bill in the supreme court lie—because of the inadequacy of the estate to pay all death taxes claimed. The supreme court appointed a master, who has taken testimony and received briefs thereon, but has not, at the present writing, turned in his report to the court.

Some of the members of this committee are of counsel in the Green case; but to the committee as a body the decision as to Mr. Green's domicile will be, of course, a matter of indifference. Yet the committee will be most interested to see what, if anything, the supreme court says with respect to the problem of multiple death tax claims based on claims of domicile. It is conceivable that something very helpful may be said.

In the meantime a suggestion has been made to this committee, by one who is not a member, which merits attention. The suggestion arises from a consideration of the procedure adopted in the Green case.

It is a not uncommon practice for states to use federal returns as the basis for the calculation of state income taxes. A federal estate tax return must be filed in the estate of every deceased person whose gross estate is over $40,000 (not counting the estates of certain non-residents of the United States). The federal estate tax

return contains a statement as to where decedent was domiciled at death. The return is normally prepared by the executor or administrator.

Would it be possible for congress to provide by statute that, whenever a federal estate tax return is filed on the estate of a resident of one of the states, (a) notice be given by the bureau of internal revenue to every individual and state which might care to controvert the statement as to domicile in the return; (b) such persons or states might be heard by the bureau on their claims as to domicile; (c) if at such hearing the controversy appears to be between individuals and cannot be satisfactorily composed, it be certified to some United States district court, which will decide the case, with the usual rights of appeal; and (d) if at such hearing before the bureau the controversy appears to be between states and cannot be satisfactorily composed, it be certified directly to the United States Supreme Court which will hear the case under its original jurisdiction of disputes between states, probably through a master, as in the Green case.

This was the form in which this suggestion came to the committee. It contains much originality and promise; but it needs expansion in order to be effective in those cases in which it does apply, and it seems to be open to criticism as being only a partial solution, and not applying to all double-domicile death tax cases.

We take up first the matter of expansion in the details of the suggestion.

(a) *Notice.* Instead of waiting until the federal estate tax return is filed, which under the present law need not be done until 15 months after decedent's death, it would seem better to provide that the filing of the preliminary notice, federal form 704, should set things in motion. This preliminary notice is required to be filed within two months after the qualification of the fiduciary. It, too, contains a statement as to decedent's domicile at death. Perhaps the time for filing could be shortened to one month. This is advisable in order to forestall the making of irrevocable decrees as to domicile by state courts, since the laws of many states provide that, upon the opening of an estate, the probate court shall make a finding as to domicile, which finding, unless appealed from, is conclusive upon all parties present or notified.

(b) *Hearing by the bureau.* No comments, except that the bureau would furnish an unprejudiced tribunal in the first instance.

(c) and (d) *Certification to the district court or the supreme court.* At some point it will be necessary that an injunction issue, prohibiting both individuals and states (if states are in controversy) from litigating the matter further in state courts — otherwise this proposed plan is nugatory. What authority may issue such an injunction? It would seem that only a federal court might be authorized to issue it; certainly the notion of congress authorizing a fed-

eral bureau or office holder to enjoin states from prosecuting litigation in their own courts is a novel one. But perhaps procedure might be devised to bring the matter into a federal court in a preliminary way, sufficient to enable that court to issue a temporary injunction in order to allow the matter to be settled in the bureau if possible, and if impossible, to be certified to the court issuing the injunction, which could then make the injunction permanent, or modify it.

To enact such an injunction provision might seem to go against the modern current of legislation; for example, S. 1551, Public Law No. 332, 75th congress, approved August 21, 1937, amends section 24 of the judicial code (the section which defines the jurisdiction of federal district courts) by adding thereto a provision that no federal district court shall have jurisdiction of any suit to enjoin, suspend, or restrain the assessment, levy or collection of any tax imposed by or pursuant to the laws of any state where a plain, speedy and efficient remedy may be had in law or in equity in the courts of such state. The reasons given in support of the passage of this act (Senate Judiciary Committee report No. 1035, 75th session) were to the following effect: It is the common practice for statutes of the various states to forbid actions in state courts to enjoin the collection of state and county taxes unless the tax law is invalid or the property is exempt from taxation, and these statutes generally provide that taxpayers may contest their taxes only in refund actions after payment under protest. This type of state legislation makes it possible for the states and their various agencies to survive while long-drawn-out tax litigation is in progress. If those to whom the federal courts are open may secure injunctive relief against the collection of (state) taxes, the highly unfair picture is presented of the citizen of the state being required to pay first and then litigate, while those privileged to sue in the federal courts need only pay what they choose and withhold the balance during the period of litigation.

Perhaps it might be argued that no plain, speedy and adequate remedy exists in state courts in double domicile cases, so that said statute would not prevent injunctions from being issued in such cases; but the states are not likely to agree to that, since a claiming state will not (by hypothesis) admit that decedent's domicile was outside its borders and must in any event have confidence in its own courts—even if that confidence is not shared by outsiders.

Moreover, it would seem that section 24 of the judicial code would have to be amended in another respect, in order to make this proposed plan effective as to (c), namely by repealing the requirement of diversity of citizenship in such of these cases as are certified to federal district courts — because it may often occur that all individuals engaged in such a controversy are citizens of the same state.

We take up next the point that this proposed solution is only partial, and does not apply to all double domicile cases. It is impossible to speak dogmatically about this, because abstruse questions appear to be involved, as to which the members of the committee are not in entire accord. It is planned to discuss these points more in detail elsewhere in this report; so that it is sufficient for present purposes to say that a majority of the committee believe that some double-domicile cases involve a dispute between an individual and a state, and not merely between two states. This would be true even if the two claimed taxes were equal in amount so that the executor would be a mere stakeholder; for even then an heir, legatee or devisee might have a claim based on which law of descent or devolution applied. At any rate, in the view of a majority of your committee, if the controversy is one between an individual and a state, then the *Hunt* case has forbidden any solution through the federal courts if the states do not consent.

Discussion of Possible Solution No. 8

In this and previous reports we have discussed seven possible solutions. In addition to these, there are the presently existing but unsatisfactory and difficult methods, which indeed are the only ones now open to an executor faced with a double domicile controversy: namely, to follow the procedure in the Green case, or to litigate the matter in all state courts, raising the federal question at the proper time, with the rather forlorn hope of arranging that appeals from the various state courts reach the United State Supreme Court at the same time, and of inducing that court to hear them.

There is, however, another possible solution, which we shall designate No. 8. It holds promise; it is comparatively simple; but whether it is practicable remains to be seen. The suggestion is (a) to have the states pass short reciprocal laws consenting in advance to being sued by a fiduciary in a federal district court in an interpleader suit. See *Clark* v. *Barnard*, 108 U. S. 436 (1883). It will be recalled that the *Hunt* case forbade this procedure because the states did not consent; (b) to have congress, by amendment of the judiciary act, give the federal district courts jurisdiction of the subject-matter.

This rather brief suggestion contains rare possibilities of argument; but there are certain points upon which, it is believed, a general agreement can be reached. A court is the best sort of forum to determine domicile, to which lawyers will turn more easily than to a board having final powers. Our legal system is in a bad way if we cannot make it possible for judges to decide a kind of dispute which threatens to exact a large sum of money from heirs twice over, unless it can be litigated. It is absurd if courts can perform minor services like aligning fences but cannot handle controversies

like the Dorrance case, the Hunt case, and the Green case in some expeditious manner, which does not depend for its availability on some adventitious circumstance like the fact in the Green case that four states claim the domicile and would eat up the estate by taxes. There ought to be a plain method that every executor can follow in these fairly frequent cases of uncertain domicile.

The court ought to be a United States court. True, state judges are not necessarily partial to their own state revenues—the Trowbridge case stands as a splendid example of judicial fairness. But the danger is there, as the tax officials of the intervening state will be well aware; and the almost solitary grandeur of the Trowbridge case shows the unfitness of the method pursued in the Trowbridge case as the regular solution.

The federal district court is the proper court. The supreme court has the advantage of prestige and greater freedom from partiality, and its original jurisdiction of interstate disputes may include our situation even without the special facts of the Green case. There are, however, marked objections. (1) One state must sue another state to come within the original jurisdiction of the supreme court. Even when a state would be willing to be sued by an executor, it may not want to go still further and initiate the litigation. (2) It is not clear how far the supreme court will allow private persons to become parties under its original jurisdiction. (3) The supreme court is too busy to work fast. (4) It ought not to be cumbered with minor questions of fact, about the number of weeks the decedent spent each year in a place and whether he used a hotel room as a bedroom or merely as a storage room. (5) The district courts are the normal place to decide issues of fact; they can take testimony in open court; the judges regard such questions as everyday matters; the proceedings are faster and cheaper.

Very well; let us assume that we are all satisfied in saying that a federal district court is the proper forum. Even if the convenience of interpleader can be so persuasively presented that the states will consent to use this machinery, the next question is extremely troublesome: can a federal district court take jurisdiction in such an interpleader suit, even if the states consent to be sued and thus remove the bar of the eleventh amendment? This question, of course, was not answered by the supreme court in its decision of the Hunt case, and is still open.

Suppose a case where an executor brings an interpleader suit in a federal district court, both states consenting to be sued. Suppose the tax claims of the two states are of exactly the same amount, so that the executor is a mere stakeholder. The executor pays the amount demanded into court, sits back, and lets the two states fight it out. (That was the theory of the Hunt case, when brought.) Is the sole controversy, then, between the two states? By analogy to strict equity interpleader, the answer would seem to be Yes, for

in equity interpleader both defendants are creditors of plaintiff, or at any rate claim to be creditors, and their claims have to be mutually exclusive and must arise out of the same transaction. The analogy to our present case is close.

But if the only controversy is between the states, then does it not follow that the federal district court has no jurisdiction, and that the case belongs in the supreme court, as an original action, under the constitution?

After painful consideration, a majority of your committee has come to the (tentative) conclusion that no controversy exists between the two states; the only controversy is between the executor and whichever of the two claiming states proves not to have been the domicile of the decedent.

One of the members who disagrees with this view puts his case strongly. He first cites the judgment of Solomon (3 Kings, 22-28), and says:

> "I respectfully submit that if you paraphrase this opinion (of Solomon's) slightly by substituting the words 'state X' for one of the women and 'state Y' for the other woman, and the word 'domicile' for the word 'child', you will have an exact description of what happens in law and in fact when state X claims that it is the domicile of A and state Y claims it is the domicile of A."
>
> ". . . The very crux of this whole thing is that X and Y are not both creditors of A. . . . One of them is a creditor, not both of them. . . . In the cited case (Solomon's judgment) only one of the women could be the mother of the child. In a disputed domicile case only one of the states could be the domicile of A. Further, neither state X nor state Y can be a creditor unless it is the domicile, and therefore the fundamental controversy as to which is the domicile must first be tried out in a single tribunal having jurisdiction. It is unsound, it seems to me, to say that the controversy between the two women could have been justly, legally or finally judged by having two different judges sitting separately and handing down separate decisions which in effect would make the child have two mothers. A child cannot have two mothers and any system of jurisprudence which says to the contrary would make 'the law an ass' (Dickens in *Oliver Twist*)."
>
> "You yourself can write what ought to be the next sentence. I am skeered that if I write it I would be guilty of contempt of court."

This is a brilliant argument by analogy; but the analogy does not hold. In Solomon's case, the only vocal people were the two women, and so the controversy seemed to be between them, and each wanted

the whole child. But the real interest to be protected was that of the child, and since it could not speak and could not be divided (as King Solomon very well knew), it was left out of the controversy. But in a double domicile case the executor is vocal, and the trouble is that the estate can be divided between the claimants. This may be just as wrong, theoretically, as dividing the child, but it has at least been condoned by the supreme court. If the child in Solomon's case had been vocal and had satisfied King Solomon that it knew its own mother and wanted to be with her, its position would have been similar to that of an executor in a double domicile case. The child would repudiate the false mother; the executor repudiates the state which is not the domicile; the child has no quarrel with its real mother; the executor has no quarrel with the state of decedent's domicile.

Which state that is may be hard to determine, and the supreme court has at least good Biblical authority for allowing the estate to be divided. But what we wish to bring out is that ultimately the controversy is not between the two states, so that the matter does not necessarily fall within the original jurisdiction of the supreme court. See *Kansas* v. *Ames*, 111 U. S. 449 (1884).

Hence it may properly be within the jurisdiction of a federal district court. But under the present rules there are certain restrictions to the exercise of that jurisdiction. For our purposes, these restrictions are in the alternative: either (a) the parties must be citizens of different states, or (b) a federal question must be involved. As to diversity of citizenship, it is quite certain that a state is not a citizen of itself; so that (a) is out, unless the requirement of diversity of citizenship be repealed with respect to our case. Then is there a federal question? We believe that there is, although here again no dogmatic statement can be made. The supreme court has, in recent years, shown a decided hostility towards double death taxation; but that hostility has waxed and waned. It reached its height in the series of death tax cases culminating in *First National Bank of Boston* v. *Maine*, from which it appeared that (laying aside questions of business situs) only the state of domicile can levy death taxes with respect to intangibles. And a man can have only one domicile at death. It would seem to be hard for the supreme court to retreat from this rule; yet in the Dorrance and Hunt cases any hostility toward double death taxes did not lead the court to go out of its way to avoid them. Perhaps the question was not properly before the court in those cases; and if the question does squarely come before the court again, we expect but cannot guarantee that the court will again evince its dislike of double death taxes.

The rule of *First National Bank of Boston* v. *Maine* was that it would be a taking of property without due process of law, and contrary to the fourteenth amendment to the constitution of the United

States, for a state which is not decedent's domicile to levy death taxes with respect to his intangibles. That is a federal question; and so it seems to us that there is a federal question in our proposed interpleader suit. In such a suit, and at the outset, it is the combined action of the two claiming states which threatens unconstitutional double taxation. In the Hunt case the supreme court looked at each set of taxing officials separately. It said that it was not wrong for the California officials to seek to have the domicile determined in their own state courts, and that the mere possibility of judicial error there did not constitute a violation of the fourteenth amendment. The court could then make the same statements about the position of the Massachusetts officials. But in our view the wrong consists in the two claims together. It may not be enough to have a possible mistake by a state court, but if both sets of officials win in their respective state courts, the wrong isn't possible, it's certain. Even if the supreme court is correct in saying that the bare chance of inconsistent findings does not *ipso facto* constitute a federal wrong, the inconsistency is here not just a rare accident. It is a very definite, very likely to occur, very expensive, easy to anticipate in advance of either judgment. And, what is more important, it is tied tightly to double taxation, which the supreme court is inclined to treat as a violation of the fourteenth amendment.

So if the states consent to be sued, and if there is a federal question, an interpleader suit would seem to lie in a federal district court. But even then some legislation by congress would probably be necessary. It would be awkward to try to amend the present Federal Interpleader Act, and, because of the subject-matter, it would seem better to attempt to amend the judiciary act by adding a subsection which (we are not using statutory language) would give the federal district courts jurisdiction of litigation to which two or more states would voluntarily be parties and also a taxpayer or the representative of a decedent, where the subject-matter in dispute is a death tax or state income tax or direct property tax on intangibles—or perhaps other taxes—when the tax in question is based on the domicile of the taxpayer or decedent in a state, and such domicile is claimed by each state joined. The venue may be in a federal district court in either claiming state, or possibly in some third state; but in the latter case perhaps the consent of the senior district judge should be required to be obtained before the suit could be filed. The trial should be without jury. The suit might be initiated by the taxpayer or executor, or by either state. This would allow the states to get together for the suit when the executor is lazy or incompetent. The states must consent, but the executor may be forced to be a party if he is not the plaintiff. The amount of the largest claim for the tax in dispute may be paid into court, or a bond may be filed. Query: whether this should stop the running of interest. The court's decision, subject to review by the circuit

court of appeals and by the supreme court, as in other cases, shall be final as to domicile for purposes of the tax. Query: whether it should also be final for purposes of devolution, etc., in order to avoid the outlandish result of having the death tax payable to state X but the distribution governed by the law of state Y. If devolution can be constitutionally adjudicated thus, then it must be permissible for next-of-kin, heirs, legatees, devisees and even creditors sometimes to intervene or be forced in as parties, in order to present their contentions where domicile would affect their interests in an estate. But perhaps this complicates issues and parties too much, so that we should stick to tax questions. In any event additional states should be allowed to intervene and put in their tax claims.

We do not favor including in such amendment any domiciliary issues in situations where a tax does not set the ball rolling. Taxes on corporations properly "allocable" among several states in proportion to business done or property held, might conveniently be handled in a unified proceeding, if desired. Let "taxpayer" be defined to include corporations and other associations as well as individuals.

The amendment should give the district court nationwide process for witnesses and private parties. It must also permit the district court to enjoin tax proceedings in courts of the states involved, as an exception to the 1937 amendment to the judicial code, mentioned above.

No doubt considerably more thought must be given to the details of this plan. Since it is proposed, at a later point in this report, that this committee be continued, we do not now recommend this or any other specific plan as a solution.

Co-operation between this Committee and the American Bar Association's Committee on Federal Taxation

The American Bar Association has, for some time, had a committee on federal taxation. In its last report, that committee turned its attention briefly to the procedural difficulties in disputes concerning domicile; after some general remarks, the report said:

> "In any real solution of this important problem, it is obvious that difficult questions of constitutional law are involved, together with many practical questions; but the search for a sound solution, whether by legislation or constitutional amendment, seems worth while."
>
> "This committee realizes that the problem here is not one of federal taxation. If, for that reason, the (American Bar) association does not desire to give a mandate on this subject to this committee, we suggest the appointment of a special committee to study the problem. If, on the other hand, it is the

wish of the (American Bar) association that this committee proceed to a study of this problem, we urge the adoption of Resolution I."

Resolution I is as follows:

"1. RESOLVED, that the American Bar Association recognizes that serious procedural difficulties arise when each of two or more states, seeking to levy death taxes against the estate of a decedent, claims that decedent was domiciled within its borders at the time of death; and that the committee on federal taxation is directed to study and report upon such procedural difficulties, and to develop, if possible, recommendations as to constitutional or statutory changes to obviate such difficulties."

The house of delegates of the American Bar Association, at its meeting in Cleveland in July, 1938, approved the recommendation of the committee on federal taxation. The chairman of that committee is Mr. George M. Morris, of Washington, D. C. If the existence of your committee is continued, it is planned to have close co-operation between, and joint meetings of the members of, both committees.

CONCLUSION

In view of the above, it is suggested that the committee be continued for another year.

Respectfully submitted,

COMMITTEE ON DOUBLE DOMICILE IN INHERITANCE TAXATION.

ZECHARIAH CHAFEE, JR.,
T. LUDLOW CHRYSTIE,
SETH T. COLE,
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WILLIAM D. KELLY,
JAMES W. MARTIN,
LINN L. REIST,
RAYMOND M. REMICK,
JAMES L. SAYLER,
FARWELL KNAPP, *Chairman.*

CHAIRMAN MCPHERSON: Now we come to the discussion of the very interesting paper, first by Mr. Dudley W. Orr, of New Hampshire State Tax Commission.

Mr. Orr!

DUDLEY W. ORR (New Hampshire): Mr. Chairman, Members of the Conference, Ladies and Gentlemen: So much of intense interest to everyone interested in death taxes has been presented here this morning that is is very difficult to know where to begin.

I propose to confine myself principally to the problem of multiple domicile, but I would like to say at the outset that the matter of the effect of the federal estate tax credit on state finance is also very absorbing. Some of you will remember that in the recent decision by the United States Supreme Court of the case involving the taxability of the income of an employee of the New York Port Authority, the learned justice who wrote the opinion suggested that there might be constitutional limitations on the state power to tax federal employees, that were not as liberal as the limitations on federal power to tax state employees.

The court went on to point out that it was possible for the states, if they didn't like the way the federal government was treating them, to get a greater share of federal revenues, or prevent the federal government from absorbing too much of potential state revenues because, after all, the federal government is operated by a congress consisting of state representatives.

My view is that that argument sounds a good deal better than it in fact works out. Mr. Knapp has cited authority from the Book of Kings. I suggest as a text for the federal government a selection from the Book of Exodus wherein it is said: "Thou shalt not covet." That might apply particularly to the federal government in this matter of inheritance tax levies.

The first of the two suggestions that I have to make in regard to the matter of multiple domicile is, that I hope the committee will not cast aside or give an unfavorable report on the possibility of settling certain of these multiple domicile cases by arbitration. In some states, for example, in my own state, New Hompshire, which is a small state, we have very high taxes on very small estates. For instance, on a net estate of $6,000, a death tax of about $500 might well be imposed. Now, the kind of solution of a double tax problem afforded in the eighth proposition just outlined to you would be out of the question, I think, in a small case like that. It would be too expensive and the result probably would be like the result in a recent case that came to my attention where the taxpayer paid taxes in two states largely because he couldn't afford to litigate the question anywhere.

I suggest that perhaps the states might adopt a simple statute authorizing their taxing authorities to submit small questions, questions involving taxes not over a certain amount, to arbitration. I think that for the most part the tax administrators would be willing to do this, and while it might not be the most perfect remedy, I agree that a judicial forum is the best place to settle these ques-

tions. It nevertheless would be better than no remedy at all and might afford considerable relief to the small taxpayers.

The second point that I want to make is one involving the question of business situs. If the United States Supreme Court should decide, as it well might, that in cases where the property has established a business situs in a state other than the one in which the decedent died, domicile might be taxed both in that state where it had a business situs and in the state of the decedent's domicile; would there then be a federal question for adjudication under the procedure outlined in solution No. 8.

Of course, it hasn't yet been decided that an *inter vivos* trust, for example, decided in Colorado, can be taxed both in Colorado and in New York upon the death of the individual who established the trust.

The New York court, as some of you probably know, decided that case with its customary self-denial, and decided that Colorado was the only state that could tax such an *inter vivos* trust, reserving an unlimited right of revocation in the settler.

I understand that the case is still pending before the United States Supreme Court, and it is yet possible that some decision of that problem should be forthcoming. From some of the cases decided in the 1936 term, it begins to look as if double taxation in cases like this would not violate the federal constitution, on the theory that both states furnish a certain amount of protection to the property, and it is not a denial of due process to permit both states to tax the property.

I am sure that the committee has this problem of business situs in mind. It mentioned it in its report, and I merely point out the difficulty of there being a federal question if the supreme court should decide these cases in the way that I have indicated. I would like to suggest that in any event, that no matter what form of procedure should be worked out, some relief should be afforded for these business situs cases, and that the remedy should not be exclusively confined to cases where the domicile of the decedent is in dispute, because double taxation may arise out of a business situs case where there is no dispute whatsoever about the domicile of the decedent.

Thank you.

CHAIRMAN MCPHERSON: I think it is a good thing that Dr. Leland came back because when Mr. Knapp and the gentleman who just spoke began to cite from the Scriptures, especially where the decisions of Solomon may have disagreed with the supreme court of the United States, it is putting us Presbyterians in a tough spot.

Dr. Leland, if you will, I wish you would come and take this over. There is just one more thing, but I want to go out and study the Bible a little bit. I think Mr. Knapp's quotation was all right

but I am not so sure that the other gentleman got it from the right book. (Applause)

(President Leland assumed the chair.)

CHAIRMAN LELAND: I believe Senator Edmonds is the next person to discuss the committee report. He has leave of the chair to quote from whatever sources, scriptural or otherwise, he cares to employ.

FRANKLIN S. EDMONDS (Pennsylvania): Mr. Chairman and Members of the conference: I think I would first like to make a statement, then an observation, and then following that, a suggestion.

First, the statement: I think the reports that have been presented by the committees to this conference represent a very high level of excellence, and that is due, in large measure, to the care with which President Leland and former presidents have appointed the committees. They have worked and have taken up very subtle and difficult subjects, and they have endeavored to make a recommendation. So long as the National Tax Association conferences can produce reports of this kind, it seems to me that it has abundant vitality for its work.

Now, then, second: I am impressed with the fact that when we wrestle with these problems of taxation, the overriding problem is the question as to how far the federal government can be used to implement the state taxing systems. That, frankly, is King Charles' head at this feast. The report of the committee quotes from Dickens, consequently I may be permitted to direct their attention to the fact that in David Copperfield, when Mr. Dick was writing his history, he couldn't keep King Charles' head out. In spite of the zealous desire of those state tax commissioners who stand for an absolutely isolated and independent system of state finance, King Charles' head keeps poking into this picture. It came in on Wednesday night when the excellent report of the committee on allocation of income was presented. It has come into the discussion today in Morrissett's excellent paper, in the discussion of gift taxes which preceded it, and now in the report of the committee which is presented by Farwell Knapp, one of the strongest proponents of independent state isolation that we have in this association.

The real fact of the matter is, gentlemen, that circumstances are forcing this question upon us for consideration, and I think we would not be true to our traditions if we continued to disregard it as something which is beyond our discussion.

We are face to face today with a situation when a certain number of functions which are properly state functions are being performed by the national government because the national government has tax resources greater than the states and, consequently, the states can-

not raise the revenues to perform what belong to them as functions, except in some way by an appeal to the federal government.

How does that arise? Well, it comes out in the crediting device under the estate tax. That is one way in which the states have appealed to the federal government. It comes out in a very much more grossly undignified way in the parade of state officials down to Washington, clapping hands, begging for a hand-out from federal funds.

It seems to me that the development of a proper system of taxation for a federated republic and indestructible union of indestructible states requires that we should recognize, as has been so frequently pointed out by the able tax commissioner of New York, the Honorable Mark Graves, that there are certain forms of taxation with which the federal government is better fitted to deal than the states. That if there is an equal right on the part of the states to use those methods of taxation, then there should be a cooperation between the federal government and the states, that cooperation working out to some sharing of the proceeds.

On that subject in the National Tax Association there is the school of Gamaliel and the school of Hillel, and those two schools agree no more than they did in the days of the New Testament.

On the one side there are some of the state tax commissioners, and the association is very largely organized under the aegis of the state tax commissioners, and they believe anything that interferes with the independence of their function means an end to the indestructibility of the state.

On the other hand, there is a group of people who feel that our citizenship to the nation, and our citizenship to the state are side by side. They are both citizenships and they are both loyalties, and while there is every now and then the fear advanced that the federal government may give something and then try to take it back again, yet I notice that when the federal government has given, it hasn't taken back again.

Perhaps the best answer to Mr. Morrissett's fear is the fact that when the question was presented to the federal government, the federal government recognized, and recognized with great definiteness, that having made commitments to the states upon which the states were relying, it was not within its proper policy to ignore those commitments.

Now, I don't want to argue any further along this line. I have argued in times past to the conference on this subject. My own private feeling some years ago was, and still is, that the National Tax Association had a position of leadership that it might well have taken in the matter. That time has now passed. My own feeling is that the association is not willing to take the position of leadership, in the first place and, in the second place, an association which is controlled so largely by the state tax commissioners doesn't

present the independent kind of view from which it should come. It should come from taxpayers, and it will be the taxpayers whom I think will next be heard of along that line.

I do not think that No. 8 exhausts all the possibilities of this subject. It is inconceivable to my mind that a committee that is composed of such well-known experts in the line should not continue, as long as the scholastics of the Middle Ages took so long in order to develop their philosophy of life. There are infinite branches that may be developed in this subject.

The Dorrance estate started this trouble. To my mind it seems rather strange for anyone to say that the decisions in the Dorrance estate in the two opposing states were correct, and yet personally I have a sneaking feeling that that is the case.

Mr. Dorrance was a wealthy man who lived in New Jersey and had his wealth in New Jersey, in stock of the Campbell Soup Company. He moved over to Pennsylvania and established a residence there for his family. But if he took a legal domicile in Pennsylvania, the question then arose of paying every year personal property taxes upon all of the stock that he enjoyed in a non-resident corporation and, therefore, he very carefully set out to establish a record of himself as a resident of New Jersey. Every statement that he made indicated that he was a resident of New Jersey. Now, when he died, this question came before two different appellate courts. One appellate court settled the question of domicile by the facts of the case: Where did the man live? Where did his family live? Where did he count apparently as his home? The other appellate court settled the case upon the statements that the man made as evidence of intention. So long as appellate courts in deciding questions of domicile continue to rely upon different rules—and there is an entire possibility that different rules may be extended—one court may say that it depends upon where the man has his physical residence, namely, where he lives and breathes; another court may say that it depends upon where the man has his business assets; another court may say it depends on his intentions as expressed by himself.

There are all sorts of possibilities that may be worked out along that line.

Under those circumstances, the committee is right in its suggestion No. 8, in feeling that the situation requires the intervention of the United States District Court in order to implement the various state laws on this subject.

I think myself that condition No. 8 is worth trying, but I want to make this prophecy on the one subject on which I can speak with some experience. I think personally I have had more experience than any other person present in propagandizing to get the state legislatures to adopt a uniform act.

In 1925, the National Tax Association conference adopted a resolution in favor of reciprocity in inheritance taxation of intangibles without any report by a committee, without any paper by a member, without any discussion on the subject, but because of an inherent feeling that the thing was right.

The association appointed a committee which did propagandize for that point of view, without regard to the constitution, without regard to the by-laws, and with the complete approval of all of the elder statesmen. We propagandized for it until eventually we had 39 states that came into the reciprocal arrangement voluntarily, and then we struck the last nine. Some were not interested; to some the taxation was a very slight matter; but there were other states that stuck out like a sore thumb and, just because the majority of states had adopted one course of action, decided that for themselves they were going to adopt another course of action. While eventually the contest was concluded satisfactorily, it was concluded by the intervention of the supreme court in Haskell's estate, referred to in this report as First National Bank of Boston, I think, versus the state of Maine. It was in Haskell's estate that the supreme court gave us finally the uniformity.

Now I have the feeling that the pressure toward uniform conditions which is developing, not only from decedents and from donors, creators of living trusts, but also from the business which pays the taxes, is so great that sooner or later in the tax system of the country the states will be obliged to rely more largely upon federal coverage than they have in the past, or else the states must resign essential functions which they ought to perform to the federal government which is less capable of performing them satisfactorily.

Now I have gone far afield in the discussion of this subject. It is the first opportunity that I have seen upon this program to present what seems to me to be an important point of view that should not be forgotten. I do not want to see these questions fought out while there is an administration which has so widely expanded the function and the program of the federal government as to lead to a doubt as to whether or not it can consider properly the relationship that the supreme court defined as an indestructible union between indestructible states. But when the time comes, and it will come, that these questions are looked upon in a more statesmanlike way, then I believe eventually this question will become the big tax question before the American people.

I have been rather persuaded of the rightness of my own point of view in noting that the suggestions that have first been made at this conference came from Mr. Houston of Illinois, and Mr. Harriss of New York, two young men. The rising tide is with us.

Chairman Leland: I want to tell Mr. Edmonds that both of those men he mentioned are my students.

MR. EDMONDS: I congratulate them very heartily on escaping the influence.

MR. LONG: Mr. President, I merely come here to set the record a bit clear. First, I was going to say, Dr. Leland, that these young in age but old in wisdom people whom Senator Edmonds called attention to were, at the beginning at least, neophytes who knelt at your altar.

He perhaps handled it better than I could have handled it.

I rather suspected that Senator Edmonds would, as always, make a very pleasant and effective appearance before you. One of the comforts and discomforts of my long association with him has been that on this subject which he emphasized with such vigor, he and I are on different sides of the fence. We have perhaps purposely put up that fence unconsciously so that we can continue to meet at gatherings of this kind, and others, and be entirely friendly, or at least not convinced—he with the federal government, whose banner he carries aloft for this purpose, and myself, with a few others, going back to the ancient period of those who carried aloft the banner of the states.

There are just two things on which I would like to make the record clear.

The first he made was a statement, and there he dipped into his vast knowledge of the Bible, and I am going to leave that to him and not resort to holy writ to support anything that I might say in that respect.

The second thing was—I don't think it was a suggestion because I don't think he meant it as a suggestion—but in it he had one particular thing that I am a little bit fearful was pretty strong argument unless you get the other side of it.

He said in substance that where the federal government had given, they did not take away, and it was my understanding that he meant by that that in the 1926 revenue act, having given the 80 per cent credit to the states, they continued it and did not take that away.

Now, if you leave it right there it is perfect, a magnanimous federal government, merciful, charitable, extremely helpful. But what has happened?

Let us take the Green case. The Green case is subjected in essence to two taxes, first, the 1936 revenue act of the federal government and then, so far as the states are concerned, the 1926 revenue act. In the 1926 revenue act, the federal government tax on the Green estate which approximates $38,000,000 would be approximately $6,500,000, and of that we would get 80 per cent, which is approximately $5,000,000. And that is where we are today. But the federal government has a 1936 revenue act and, under that, their tax against the estate of Mr. Green of $38,000,000 is $23,000,000. Where is the magnanimity in the stretch between the $6,500,000 and the $23,000,000 which they get?

They have softened us up a little bit perhaps by saying that, "we will keep that act as it is and give you the 80 per cent credit." But real magnanimity and a real indication of what they might do in the future would have been more manifest if, as they moved forward the tax, we would have been given 80 per cent, because if we could have been given 80 per cent of $23,000,000 — whether Mr. Cole, representative of New York, wins, or whether Massachusetts, Florida or Texas wins—we would be much more grateful to this federal government than we can under the present circumstances where, at best we can only get, whichever state wins, approximately $5,000,000, and the federal government will get approximately $17,000,000. That $17,000,000 could be spread among a great many states through the federal use, and I am fearful that that is an indication of exactly what the federal government will do if it, in the suggestion of Senator Edmonds, has the right of way.

I hope sometime Senator Edmonds will join with me, if not in abandonment of the estate tax by the federal government, at least in the sweeping away of all of the subsequent acts, and a reenactment of the 1926 revenue act, unless perchance he wants, or others want, the rates a little bit higher.

In any event, the federal government isn't very charitable.

The second suggestion was that the National Tax Association had supported, and perhaps had incited, or at least had given, some indication that they wanted to propagandize in respect to the inheritance tax and reciprocity. Of course, that would be a rather difficult thing for us to leave in our records, because we have only recently had some discussion with the federal government as to whether we are a propaganda organization or not. Technically we are in a conference and not in the National Tax Association, and the conference of 1938 began in Detroit and it dies in Detroit. It is not a perpetuating thing, and what we say at the present moment really relates to a conference, but I would not want it to appear, and I don't think Senator Edmonds wants it to appear, as the National Tax Association in the purposes which were read last night by Professor Lutz.

Professor Lutz last night, you know, called attention to the fact that that is one of the things we did not do. What the association did in that case was, in the first instance, to have a few of those who were interested in inheritance tax administration gather more or less outside of the conference and discuss the problem which was growing. The final result was, as Senator Edmonds has called to attention, but it was not a spontaneous thing, as we had discussed it among ourselves, some of those who were interested in inheritance taxation, long before it flowered at the time that Senator Edmonds calls to attention.

So I know he doesn't want to leave with this conference, or any of the association members, that the association itself favored, or at

any time did undertake, to bring about, through propaganda, this reciprocal relation which ultimately was taken care of in the decisions which have been called to attention.

What was accomplished by Senator Edmonds while chairman of the reciprocity committee, however, was very remarkable. He did three wonderful things. First, he did make clear through his efforts that it was unwise for the states to be in substance taxing in a way under the inheritance tax law, which brought a good deal of discomfiture.

The second thing was, he brought together from time to time groups of people who have contributed very much to the tax part of the activities of the states.

Third, he has given you the advantage always of appearing before you and helping you out tremendously in these meetings, and has been, and will continue to be, one of our very best members, and, as a former president, we hope he will come here very frequently, even though he may feel that Harrisburg is his proper seat of activity. (Laughter)

I also want to add this final statement, that the report of Mr. Knapp is very remarkable, and I want to call the attention of the conference that the personal sacrifice and expense Mr. Knapp has gone to in getting this together has been substantial, and that his being here with us today is much more of a sacrifice than it would seem to me most of us would be in a position to make. I wish that he had told, outside of his report, some of the detailed conferences that he has had, and some of the contacts that he has been able to develop with people who are very strong in their thought as to what the legal developments should be in this particular subject matter which has been assigned to his committee. I am hoping that those of you who are particularly interested in it will contact him, because he has a vast store, in addition to this idea of Solomon and the child, of information and knowledge which he can contribute to you in respect to this double domicile problem.

Royal B. Cushing (Illinois): I rise rather to ask a question than to contribute any particular light to this discussion.

We hear the supreme court of the United States so often saying there is no federal question involved and refusing to take jurisdiction of these questions. It just occurs to me that perhaps there is a simple answer to this question, that the federal government is, after all, much interested in all these cases. For in the Hunt case and the Green and Dorrance cases, is it not true that under this 1926 act, with the 80 per cent credit given to all state taxes paid, that it reduced materially the tax paid to the federal government? Is that the case? Perhaps your simple answer will show my question is a silly one, and I am perfectly willing.

Mr. Knapp: May I say that in an estate of large size, as these cases are, the Hunt, the Green and the Dorrance cases, it would not make any difference in the amount of the federal estate tax, whether one or two or four state death taxes were paid because, as I understand it, the 80 per cent credit clause gives a credit against the 1926 federal estate tax up to the amount of 80 per cent if state death taxes reach that amount. If state taxes are more than that, the credit is not increased.

Mr. Cushing: It is not increased but there is a credit to that extent.

Mr. Knapp: There is a credit to that extent, but in an estate of, say, over $1,000,000, ordinarily the death tax of one state will equal the 80 per cent credit.

Chairman Leland: With you kind indulgence, we will adjourn this discussion until 2:00 o'clock this afternoon and proceed with the reading of the resolutions.

Mr. Long, chairman of the resolutions committee.

Mr. Long: All that the chairman can do is submit the report of the resolutions committee and ask that it be considered later.

The first resolution is:

> "Resolved, that the conference recommend to the National Tax Association the continuance of the committee on allocation of income."

The second resolution is:

> "Resolved, that the National Tax Association recognize the need for more adequate financial statistics dealing with states and local governments, and urge the bureau of the census through its division of financial statistics of cities to make every possible effort to expand the scope and coverage of the work it is now doing in the compilation of statistics of states and statistics of cities."

The third resolution is:

> "Whereas, the committee on allocation of income of the National Tax Association has presented a report to this conference disapproving of the growing practice of legislatures in the several states of granting permission to jurisdictions smaller than states to levy taxes based on gross income, gross receipts, or net income; and
>
> "Whereas, it appears to this conference that any growth of this practice will result in the defeat of any attempt at uniformity in allocating income and in this respect make worse an already bad situation; now, therefore, be it

"RESOLVED, that it is the sense of this conference that no governmental unit exercising the power to tax within a smaller governmental unit than the state (excluding from the scope hereof the District of Columbia) be authorized to impose taxes on, or measured by, gross receipts, gross income, or net income."

The final resolution is as follows:

"RESOLVED, that the Thirty-first Annual Conference on taxation takes this method of expressing its high appreciation to those in charge of the arrangements for the accommodation and entertainment of its delegates and guests and for the most generous provisions made for their comfort and pleasure which have rendered their visit to Detroit most enjoyable and profitable; and it particularly desires to record in its minutes recognition of those individual members whose valued and signal contributions have marked the proceedings of this conference with a degree of distinction and influence."

The resolutions committee offers the above as its report, which will be acted upon at a future meeting.

CHAIRMAN LELAND: These resolutions will come up at the evening session and we will adjourn until at such time as this room is vacated, about 2:00 o'clock.

There are reports of this double domicile committee at the desk, and those of you who do not have them can get them here.

(The meeting thereupon adjourned at twelve o'clock.)

FIFTEENTH SESSION

Friday, October 28, 1938, 2:10 P. M.

Chairman Leland: We will start off with the discussion where we left off this morning.

I would suggest that we limit our discussion here to essential points and proceed with about three minutes rather than a longer period so as to give more people a chance to speak inasmuch as we are due to start another session shortly.

Edward P. Doyle (New York): I merely want to speak for the real estate board of New York and all the taxpaying organizations of the city of New York. I represent sixty-one of them.

I have listened patiently here to the elegantly phrased speeches of the college professors, elegant in diction and rhetoric, but never really containing any practical matter. I listened, of course, to the statements of the tax commissioners who are more interested in getting revenue than they are in protecting the taxpayer, except Zoercher there in Indiana. He has a splendid plan in his state. I think you ought to hear a taxpayer once in a while.

Chairman Leland: We have offered you the floor for three minutes only because we have a very short time for discussion.

Mr. Doyle: I want to give you two illustrations of why I think you ought to do something about these inheritance taxes. We all believe in New York that the depression that began some time ago, but was accelerated since 1933, is continued very largely because of the inheritance taxes and other taxes, but the inheritance particularly.

For instance, the man who succeeded me as president of the largest utility company in my city died in 1929. He left an estate of $15,000,000. Most of his securities were utility securities the same as mine were at that time. His estate was appraised at $15,000,000, but they haven't had money enough yet to pay the inheritance tax.

A friend of mine died three years ago leaving $8,000,000. Whenever a rich man dies in New York all his personal property is immediately dumped on the market to pay the inheritance tax. That leaves nothing but the real estate. The family of this man who left $8,000,000 three years ago is now in want. They offered for sale a piece of property assessed at $500,000 only a week or

two ago for $80,000—a piece of property on Fifth Avenue assessed at $500,000—but they have to have money.

There was a man ready to buy but when he discovered it had a deficit every year of $2,500, he didn't see why he should pay $80,000 to get a deficit of $2,500 a year, and the sale didn't go through.

Unless you do something about these enormous inheritance taxes that take all the personal property of a rich man when he dies and just leaves the real estate to be dumped on the market, you are going to have a very serious condition of affairs.

The result is that I had to tell the city planning commission in New York on Tuesday that we were beyond our debt limit and couldn't appropriate a cent. They had before them a program for $156,000,000 more.

New York City and New York State will cease to be a revenue state if you don't do something about some of those enormous taxes.

CHAIRMAN LELAND: Thank you, Mr. Doyle.

WILLIAM A. SUTHERLAND (Georgia): I am a neophyte here and I am delighted that after Mr. Harriss spoke, somebody told me where he got some of the wonderful information he gave us. I want to make arrangements with you, Doctor Leland, before the conference is over about taking some of your courses out there because he tells me he found out exactly what you do to make a gift not in contemplation of death. If he can really get that from the court decisions, I have been misleading some of my clients terribly, or else they have been in the hands of the wrong lawyer because, to save my life, I can't figure from the recent court decisions anything about what the supreme court is going to hold in the next two or three years about what constitutes a gift in contemplation of death. I haven't talked to anybody who claimed to know except Mr. Harriss. If he got that from you, Doctor Leland, I want to come out and take your course.

CHAIRMAN LELAND: I think we had better give Harriss credit for that himself.

MR. SUTHERLAND: I would like Mr. Harriss to explain a little about that because I am afraid Dr. Leland is going to be flooded with letters from lawyers all over the country to find out what the secret is about this subject before we get through.

LOWELL HARRISS (New York): What I was referring to is the fact of the time of motives—that, of course, recognizes living motives—and the importance attached, since the Wells case, to living motives, such as making gifts to avoid payment of income tax. Well, I mean, most gifts, I think, result from the fact that there is going to be income tax savings. That is a legitimate motive recognized by any court. There are others, such as planning a trip

around the world five years from now, or taking a long-term lease on an apartment, or buying annuities without refund provisions.

MR. SUTHERLAND: Mr. Harris, it seems to me that there you are talking about some of the evidence which may go to show that there are other motives rather than contemplation of death. But if you take the Astor case which was decided certainly by a court that most of the lawyers in the country, probably, consider the best court in the United States—perhaps a great many of them think it is better even than the United States Supreme Court — they talk about what percentage the contemplation of death motive bore to the other, and although I think the court held that 10 or 15 per cent would constitute the contemplation of death motive, a substantial motive; if we are going to have anything like that, I wouldn't say that persons rarely create trusts, make gifts and pay large gift taxes where there isn't some desire to save inheritance taxes. If that constitutes a gift in contemplation of death, then it wouldn't matter that you had other perfectly good motives.

I don't know whether that case is going to be upheld if it gets into the supreme court. I am not certain whether certiorari has been denied in that case or not, but that upsets everything that we have thought. Yet it comes from a court that has such standing in the country we certainly cannot ignore it.

MR. HARRISS: I am not familiar with the details of the decision, whether they said that one motive was enough. As I remember the facts of the Astor case, it is one of those cases where you wonder why the estate ever thought it had any case at all to stand on.

MR. SUTHERLAND: I would concede that that case is one where the facts are very strong in favor of the government in good or bad cases. Hard cases are very apt to make bad law. But yet the judge there instructed the jury—as I recall it; they came back in and asked what percentage would the desire to save inheritance taxes have to bear to all of the other motives inducing the gift in order for it to be substantial—and I think the court told them 15 or 20 per cent certainly would constitute a substantial motive, and that if that motive was a substantial motive in actuating the gift, then it was one in contemplation of death.

The case came to the circuit court of appeals on the correctness of that charge and the judgment of the lower court was upheld; the verdict of the jury finding in favor of the government was upheld.

MR. HARRISS: The impression I wanted to get over was not cases like the Astor case where everything pointed to the fact that that is what he was doing. Of course, there the only way the government got the evidence was rather by a fluke than by the ordinary procedure, but a case where health is not particularly bad and

the man is not particularly old. I mean, it seems to me so easy to set up these living motives, that you may not get 100 per cent insurance, unless the courts do recognize the principle of 10 or 15 per cent—and I don't believe there have been many decisions based on such a thing—that is, certainly the past decisions haven't been.

MR. SUTHERLAND: We thought we knew something when we got the Wells case. That case proved a very safe guide according to the decisions of the lower courts. Now, with a case like the Astor case coming in the second circuit, frankly, it leaves me in very great doubt about any of these cases where there is any large saving of inheritance taxes from the making of a gift, because that case, in the opinion of the Second Circuit Court of Appeals and the charge of the lower court, did not make it depend on whether or not the man was contemplating death any time in the near future. It made it dependent on the motive to save inheritance taxes.

In the large majority of trusts that are created where a large gift tax is paid, I would certainly say that one of the substantial motives is the desire to save inheritance taxes. I was in very great doubt about it and I wondered seriously whether, with a paper like that being published, you wouldn't want to make some slight correction in your statement, because I don't believe that would meet the approval of the bar generally, to say you can look at the cases now and find out what does constitute a gift, one in contemplation of death, and what does not. I think it is a very doubtful question.

MR. HARRISS: I didn't want to state it too strongly, but I still think that at least the chances of having the cards stacked in favor of the taxpayer and his chances of saving tax are still pretty good.

MR. SUTHERLAND: I hope you are right. It will save me considerable embarrassment.

PAUL E. FARRIER (Illinois): With Mr. Harriss' permission, I would like to pick on him again, just to correct one slight misunderstanding.

Mr. Harriss has another beautiful scheme for avoiding taxes which I couldn't agree with and which we discussed after the session this morning. I believe he made the statement that a resident of one state could avoid gift taxes by creating a trust in another state. As I told him, I wish that were true because my institution could get a lot of trust business from the state of Wisconsin which we are now unable to get. He cited the Virginia Safe Deposit Company case in support of it, and we discussed it, and I think he agreed that it probably didn't support that principle.

The Virginia Safe Deposit Company case, as you recall, was a question of property taxes on a trust being administered in another state and legal title held in the other state, and this was an attempt

to apply the property taxes to the equitable interest in the trust which the court said could not be done.

I assume Mr. Harriss was going on the assumption that the situs of the property was outside the state. Now, it is perfectly true that one can give away real estate outside of the state and probably avoid the gift taxes in the state of the domicile. And it is possible that if the supreme court says that only the state of the situs of a trust has jurisdiction to tax it rather than the state of domicile possibly some time in the future one might be able to create a trust in another state, make it revocable so there is no gift tax at the time, leave it there long enough to acquire business situs in that state, and then make it irrevocable; if, as I say, the situs theory is upheld, the probabilities are that that might save gift taxes. But, as was pointed out subsequently, that question is still in very grave doubt.

Chairman Leland: Any other questions?

C. H. Scott (District of Columbia): I would like to ask Mr. Long this question in reference to exemption on inheritance on life insurance. I believe you now have an exemption of $40,000. Suppose today I should buy a fully paid-up life insurance contract from the John Hancock Life Insurance Company by giving a check of $15,000, we will say, that would purchase me $28,000, paid up; I should assign that to my wife and three babies, and in making that assignment, I assign all my rights in that policy. In other words, I would never have the privilege of borrowing on that policy in the future. I have signed everything over—irrevocably, we might say, from my angle.

After two or three years, in case of my death, is that $28,000 exempted, in addition to the $40,000 I am allowed anyway on my taxes?

Mr. Long: If you mean me, under the Massachusetts law, we do not tax the insurance at all where it is made payable to a named beneficiary, so we do not have the $40,000 exemption.

In the case that you cite, Massachusetts would not hold that as a part of the property subject to the inheritance tax in Massachusetts. We are very easy on the insurance people.

Chairman Leland: Any other questions? You cannot adjourn this session yet because the afternoon session isn't due to start for five minutes. At least there ought to be that much conversation left about this topic.

Mr. Sutherland: Could I ask another question? I would like very much to know what your personal view is about the more or less favoritism that is shown to insurance by Massachusetts, and to some extent by the federal government, over other types of property in connection with inheritance tax?

Mr. Long: I am very glad to answer that, if I can use three minutes more.

The first one is this, in answer to Mr. Sutherland: I think we have been too easy on the insurance companies, but that is merely a continuation of what we have in our inheritance tax structure, because we say in substance that those who are near to the decedent, the immediate family, can have a very substantial amount of money that comes to them without tax. Second, they can have very small rates, because we start at 1 and 2 and 3 per cent with wide spreads. That being so, and it being possible in the average family to leave about $50,000 without tax under our inheritance tax, and on the assumption that the average insurance policy would be under $50,000 going to a family, I suppose there is some relationship between the two.

However, my own personal opinion is that we have to do two things. First, we have been too liberal with regard to those fortunes going to the immediate family because, in many instances, $50,000 fortunes were going without a single tax. Second, we are making it a little too easy on the insurance companies.

So my personal observation is that we will ultimately have to change, but we have got to get a change of thought.

We have this peculiar case, on which we have just filed an original bill of complaint in the United States Supreme Court, and I would be very glad to send you a copy of what we are asking them to do.

We took a leaf out of the book covering the Green case. A woman by the name of Madge Barney Blake died domiciled in Massachusetts. She had always lived there.

Some time prior to her death—I think I said yesterday in regard to California, subsequent to death, so they thought the person had gone to California instead of heaven—Madge Barney Blake set up in Missouri, in the St. Louis Trust Company, a substantial fortune, with the income payable to her during life. It was an irrevocable trust and she could do anything she wished with it at any time, but she had the income for life and she did file that amount with Massachusetts under the income tax law.

She died, and, unfortunately, she only left about $12,250 that we could seize in Massachusetts although the whole estate was probated. Therefore, we cannot tax this property which passed because of her death on the ground that she was domiciled in Missouri.

Missouri is very friendly about it and this is a perfectly friendly relationship, but they are of the opinion that there is a tax which may possibly grow out of the trust which is located, presumptively on business situs, in St. Louis.

So we are now before the United States Supreme Court asking whether or not Missouri can tax that trust, about $5,000,000, be-

cause she died without changing the benefits of the trust to beneficiaries who lived there, even though she was clearly domiciled in Massachusetts and clearly had the right to do anything she wanted with the property up until death. Whether or not it passed under the terms of the original instrument, to which she added six other instruments as she added more money to it, is the question we should hope the court will settle.

But there are two points I want to emphasize: the first is that Missouri apparently has nothing in their statute which permits them to compromise with me because, carrying out the doctrine laid down this morning, it seems to me that that kind of a case is the kind that as tax administrator from Massachusetts I ought to be able, with the tax administrator from Missouri, to settle with so much paid to Missouri and so much to Massachusetts, but they say they cannot do it because their statute doesn't permit it.

Therefore, I would offer a plea that the states do put into their law some kind of a provision so that it is elastic enough for tax administrators, assuming they act with reasonable honesty, to the extent that they have it in these kind of cases.

The second point is, we are of the opinion that the words "business situs" when ultimately determined by the court is not going to mean the mere fact that the title of property is there, or that you collect interest on it, or you deposit it, but rather that the business situs is to be determined only because that property is so mingled with the commodities, the financial commodities of that estate, that it is used back and forth, purchase and sale, as a part of the financial structure of that estate.

Now, however it will come out I don't know, but it is one of the things where we have a perfectly friendly approach to the court, and I think you will hear more about the Madge Barney Blake case, Massachusetts vs. Missouri.

SETH T. COLE (New York): You say you are now before the United States Supreme Court. What do you mean?

MR. LONG: We are before them in the position of handing in this bill of complaint asking them to exempt jurisdiction.

MR. COLE: They haven't taken jurisdiction?

MR. LONG: In the sense of physically before rather than legally before them.

IRWIN ARNOVITZ (Utah): Following up the question Mr. Scott asked a moment ago, I would like to direct the question to Mr. Long. If in his state they do not attempt to reach the proceeds or the funds in the type of situation which I give, then if anyone else can answer it or tell me what the practice is in their state, I should like to know it.

In the case Mr. Scott put, let us say a single premium of $12,000 or $15,000 is paid and within one year the insured dies.

Now, assuming in that state they have the benefit of the presumption that a gift made within, or rather a transfer made within three years of death is in contemplation of death, I am wondering, Mr. Long, would you in that type of a situation attempt to reach, if not the proceeds of the insurance policy, at least the amount of the single premium, contending that was transferable within contemplation of death?

MR. LONG: We would not for this reason, and it isn't a very good one: we feel, as Mr. Sutherland, that when it comes to contemplation of death, we don't know what the law is. In fact, I have a case right now where I am going to try it out as to whether it was contemplation of death or not. We have in your section of the country the Spreckels case in California, in which, if we follow the rule there, there is no such thing as contemplation of death; as against the other extreme that Mr. Sutherland gave, the suggestion that if there is a 10, 15 or 20 per cent presumption, somebody did give something on the ordinary contemplation of death, either because of taking a trip abroad or making a will, or the contemplation of death that caused him to take on casualty insurance. We have those two extremes.

In your case, however, our court would have held that the gift—I hate to call it gift, I was trying to think of something else—the property right would go to the one in whom it was vested at that time. Therefore there was nothing under our law which caused a taxable transaction to develop, because we say, "Whatever passes by deed, grant or gift." That being so, you couldn't put in either one of those, because if it was a gift, then it had vested in the person to whom it was given at the time when the person giving it, the donor, was alive, and the death of the donor didn't give him anything he didn't have before.

CHAIRMAN LELAND: We have transgressed now upon the time of the afternoon session. Is there anyone who has an urge to have some point settled? I hereby declare the morning session adjourned, and I want to turn over the gavel to my good friend, Philip Zoercher, of Indiana, who will conduct the afternoon session on public policies in reference to taxation.

Thank you.

PHILIP ZOERCHER, presiding.

CHAIRMAN ZOERCHER: Of course you have all come here to listen and learn, and first on the program this afternoon is "Constructive Economy in Government." The first speaker is Willis H. Hall, manager, industrial department, Detroit Board of Commerce.

CONSTRUCTIVE ECONOMY IN GOVERNMENT

WILLIS H. HALL
Manager, Tax Research Department,
Detroit Board of Commerce

It has been said that taxation is the price we pay for civilization. Since the beginning of civilization people have protested against high taxes and extravagant and inefficient government. Down through the ages high taxes have led to revolution and revolt. Rulers and governments have been overthrown. But each succeeding government levied increasing taxes and became more expensive.

We will never achieve constructive economy in government until public officials take a more constructive interest in economical government and—more important—until the people themselves take a more constructive interest in their public officials and in economical government. Nearly all governmental costs can be traced to the demand of minority groups of citizens for new and additional services from government. Public officials feel that they must give consideration to the demands of these minority pressure groups. If the groups wanting or demanding additional governmental services and expenditures appear to outnumber those opposed to added expenditures — public officials usually go along with the seeming majority. The taxpayers are unorganized and ineffective in presenting their side of the problem. Collectively taxpayers can outvote the tax spenders if they would determine to do so. When they do public officials will realize that economical government is the first demand of the citizens and governmental expenditures will be reduced. My first suggestion for constructive economy in government is the organization of militant taxpayers' associations in each state. The merits of taxpayers' associations have received considerable discussion on your program and I need not enlarge further on this subject. However, I would like to remind the business men attending this session that they spend millions of dollars annually in research to discover better methods of manufacturing and distributing a better product at a lower cost. Today we realize that much of the savings to the consumer resulting from this research is consumed by higher taxes which must be included in the price the consumer pays for the products of business and industry. Therefore business should give consideration to slightly increased appropriations to research in taxation and governmental costs and to the support of efficient, well-organized taxpayers' associations. It will be good business economy.

Seventy-three years ago Salmon P. Chase, secretary of the treasury under Abraham Lincoln and later chief justice of the supreme court, described our fundamental theory of democracy in the following words:

> "The old theory of our fathers is the true theory. Let us have a poor government and a rich people — light taxes and abundant individual enterprise, economical expenditure and steady prosperity, a general government strictly limited in its sphere, and state governments respected and honored because competent and ready to protect the rights and guard the interests of the people."

How far we have strayed from these concepts of democracy during seventy-three years:

Instead of a poor government we have a federal government that has a corner on the world's gold (even though we find reasons to bury a large part of it under the blue grass of Kentucky). We have a poor people—so poor that more than 20 million of them are looking to government for their principal support. Light taxes have been replaced by the heaviest normal taxes in the history of this nation and many units of government — having exhausted all normal methods of taxation—are constantly seeking new methods of taxing our people.

Abundant individual enterprise is dying out because government taxation and regimentation is curbing the freedom and initiative of our people. A general government, strictly limited to its sphere has been supplanted by a government that seeks to regulate our every act. State governments respected and honored because competent and ready to protect the rights and guard the interests of the people have been overrun by a horde of federal agents sent out from Washington to administer our affairs.

As a nation we boasted of states rights. As citizens of local communities we obtained home rule—all to what end. Home rule is rapidly being bartered for state aid and states rights are being usurped by the federal government in return for federal aid.

The democracy of our fathers is dying. No longer can the citizens meet in the town hall and decide their problems. They must send their emissary to the state capitol to plead their case. And in turn the states look to Washington for help and guidance. Democracy—government by the people — has been replaced with democracy—subsidized by bureaucracy. The unfortunate part of this whole sorry scheme of things is that we are being subsidized and regimented with our own money.

Government has no money except that taken from the people—government never created a single wealth-producing enterprise. The only wealth in existence today that forms the basis of governmental taxation is the wealth created by the work and sacrifice of our people.

The system of state and federal subsidy and grants in aid that has grown so rapidly during the past eight years must be drastically revised before we can have constructive economy in government.

That revision will not be easy. But it must come if we are to escape national bankruptcy. Most state and federal appropriations of funds for subsidy and grants in aid are an open invitation for the grab-bag politicians of communities and states to come and get it while the public purse is open. Even many business and civic organization have adopted the defeatist attitude that signifies, "If we don't get it someone else will, so we might as well go after it." And then those same groups protest against high taxes and unbalanced budgets.

We will have to face this problem squarely and sanely. This money that is being doled out by Washington and the states is not government's money, but money drained from the forces of wealth production of the nation.

An equal item of extravagance and waste in connection with this system of subsidized government is the cost of supervising the distribution.

Every dollar of federal money returned to a state is accompanied by some regulation and supervision. In many instances Washington sends its emissaries into the states to direct the spending—the hiring and the firing.

This vast scheme of taking from these that have in order to give to those who have less and want more, requires a tremendous army of federal servants. They are located in every county in America and the tax burden to support them and their activities is stifling initiative, enterprise, employment and the production of wealth. It is the penalty we pay for selling states' rights for a federal subsidy.

For constructive economy in government let's return more responsibility to state and local units of government and repeal the federal tax levies for federal aid.

The next suggestion for constructive economy in government is the reduction of the units of government and the elimination of overlapping duties and functions of government, federal, state and local. There is nothing new about this suggestion. It is older than this association. But the conglomerate mess of governmental units and bureaus grows larger. For example, think of the many governmental agencies in Washington that are loaning money, trying to promote housing, examining banks, aiding the farmer and doling out relief. Congress—not the executive—should proceed at once to reorganize federal departments, bureaus and agencies.

You gentlemen representing state and local tax units, with the aid and advice of professors of government and taxation, business men and tax experts, should proceed at once to reorganize the 175,000 local units of government in the United States. Michigan with its 8900 tax units, Wisconsin with its 9500 tax units and Illinois with its 17,000 tax units is a sorry reflection on our intelligence and initiative.

Recent surveys show that three-fifths of our taxation problem is right at home — township, school district, city, county and state. Automotive transportation and hard roads have eliminated the necessity for small tax units, originally based upon distance traveled afoot, on horseback or by horse and buggy.

While the federal tax problem — the other two-fifths — demands intense action, the local situation must be remedied.

Public officials must learn to look in toward the problem and eliminate extravagance—not constantly look out for something new to tax.

The salvation of our economic structure depends upon a revision of our system of overlapping tax units as a basis for revised tax legislation.

There is no conflict between the suggestion that we return more responsibility to the state and local governments and the need for eliminating countless thousands of small tax units. We cannot hope to have responsible local units of government until we merge many small units into one community unit that will have sufficient political strength to stand up and defend itself against state domination. During the past five years we have witnessed amazing experiments in government. But all the experiments have been in the direction of an expanding government. What we need is some experimentation in contraction and consolidation of government. The tax officials of the nation have an enviable opportunity to demonstrate constructive governmental economy by tackling this job.

Many people demand that we have a more business-like administration of our governmental affairs. They think that if we could only instill business administration into government — government would then be able to render more and better service at a lower cost. That is an admirable ideal but it will never be attained. Why? Because we the people will never pay sufficient compensation to attract business ability in the field of governmental service. For example, business and industry pay management executives on the basis of their ability to produce profits. A good business executive of a corporation comparable in size to the municipal corporations of New York, Chicago or Philadelphia would earn from $50,000 to $200,000 per year. Can you imagine the uproar of the people that would follow the suggestion that these cities employ business managers at such a salary? But that could be the most economical investment in government that the taxpayers could make. A study of the municipal payroll of any large city reveals this serious defect. There are too few well-paid executives and far too many over-paid people in minor positions. This is a problem that able business management—not political management—could solve with tremendous savings to the taxpayer.

We have heard much during the past ten years regarding the bonus system of private business. Bonuses based on extra profits

earned by skillful management. Have you ever heard of a bonus being paid to a public employee for extra thrift in the management of public affairs?—No! Why? Because we seem to be developing a political philosophy that the best political administrator is the one who can accumulate the largest deficit through the lavishment of more services on the public. We have competition and sometimes bitter struggles between governmental agencies to determine which one is the most prolific in governmental services of sometimes questionable value. The whole philosophy is wrong and extravagant. We should reverse the procedure and offer a bonus to the public official who operates his department with the largest saving under his appropriation allowance. The bonus should be liberal and should be based on the proportionate saving under the department's budget. Some governmental departments would be able to save more than others. Some small department might be able to show a 25% reduction in operating costs while larger departments saved only 10 to 15%. But the interest and attention of the public official would be focused on economy, thrift and saving the taxpayers' money—rather than on more grandiose schemes to spend the tax dollar. The bonus for results would be the incentive that would attract and inspire better management of public business.

If you want constructive economy in government pay your public officials, in management positions, a larger salary with a bonus based on the savings they could produce through a more efficient administration of their departments.

Now a suggestion to all citizens. You have an obligation to yourself—your community, your state and your country—if you really want constructive economy in government, know your public officials. You place them in office—and you can remove them from office by your vote. You will have to give the job of government your continuing interest. I am safe in stating that not half of this audience can name the members of their local city council or board of aldermen. You can't name your representative or senator in the state legislature. Not many can tell me who their congressman is. That ignorance on our part is one of the causes of extravagance and waste in American government.

Usually the only time we contact our public officials is when we want something from government that will cost money or when we want to defeat some legislation that we oppose.

Some of us get enthused and excited about our public officials just prior to elections; then after election we forget them, neglect them, and cuss them if they don't perform as we expected.

But remember this, the minority pressure groups are on the neck of the public official—day in and day out—seeking, exhorting him to render some governmental service that costs tax dollars.

We are prone to criticize our public officials when we are displeased but we seldom take time to compliment them or give them a little friendly encouragement when they render faithful, efficient public service.

We pay more attention to the employment of a domestic servant than we do to the employment of our public servant that we elect to office.

So, finally, if you want constructive economy in government, know your public officials, let them know that you are interested in them and their problems, give them the benefit of your advice when they need it, tell them when you think they have made a mistake, but, most important of all, tell them when they are doing a good job.

CHAIRMAN ZOERCHER: Thank you for that splendid paper.

The next speaker is J. V. Giblin, of the Alexander Publishing Company, Inc., New York City, on the subject of "Public Expenditures and Taxable Capacity."

J. V. GIBLIN: Mr. Chairman and Members of the Conference: I am afraid I may duplicate some of what Mr. Hall has said but I guess it will be alright.

PUBLIC EXPENDITURES AND TAXABLE CAPACITY

JAMES V. GIBLIN, EDITOR

The Alexander Publishing Company, Inc.

Mr. Chairman, Members of the National Tax Association, the subject assigned, as you have just been told, is "Public Expenditures and Taxable Capacity." Perhaps, stated in simple language, the topic should read: Can taxation keep up with Government Expenditures?

I'm afraid it is beyond the ability of this speaker to answer the question. I have uncovered a great wealth of facts and figures—but the conclusion to which they lead me is one of so profound a significance that I prefer you to answer the question—rather than myself.

Here are the facts on which your conclusions must be based. Let us first see how much we are spending, before we examine our capacity to pay that bill.

You know as well as I that before the world war the federal debt was only $1,200,000,000; it rose to 25 billion in 1919; it dropped to 16 billion at the end of 1931 (fiscal year). It is today $38,423,-000,000. The president's own estimate is that it will be $40,650,-000,000 next June. I have stated in one of our own publications that it will be at least $42,000,000,000 then. And that is not all; the recent study of tax-exempt securities shows that there are

$10,547,000,000 in obligations outstanding through federal agencies, of which 3 billion is held by the U. S., making our debt not 40 billion but 47 billion. True, there are commitments against this 7 billion, probably only 3 to 4 billion is actually debt. This makes our debt by next June at least 46 billion. It was 16 billion in 1931; in eight years it has increased exactly 30 billions, or close to 4 billion each year. State and municipal debts are $19,152, 000,000, last accurate figure 1937, hence at least 20 billion now.

It is evident, then, that the federal government has, for the past eight years, been spending 4 billion a year more in what we call here this afternoon "public expenditures" — four billion dollars a year more than it collects in taxes. And this year's expenditures are over 9 billion.

As for the states' expenditures, figures are estimates, inaccurate but roughly correct enough for purpose of our topic. Last official figures (U. S. Chamber of Commerce) were for 1936, $6,550,000,000; estimate for this year is $7,500,000,000. The taxes and the expenditures are near enough the same.

Come with me a further step. The National Conference Board reports that federal and state governments expended for 1938 the sum of $16,900,000,000. We are still speaking only of expenditures. What of the coming year? The President wants 300 to 500 million for defense; payroll taxes are now 5% (employer-employee), they will soon be 9%; for defense and payroll expenditures, not collections, we face an increase. Mr. Wallace wants 300 to 500 million through AAA taxes; the social security board (Mr. Altmeyer speaking), wants to extend the benefits; he states in a speech delivered in Kansas City, Wednesday (I have it here in full), that $915,000,000 more is needed for welfare this coming year. Our expenditures are $16,900,000,000—and the figure seems very nearly correct—and they must be higher next year.

All right, let us look at the other side just a minute, beneath the surface, if you will. The social security board (speech by Altmeyer last week, Richmond, Va.) says the government supports 21,000,000 people through direct and indirect relief. If you are interested in figures, this conclusion is reached somewhat as follows: 40,000 needy blind supported, 618,000 dependent children supported, 1,700,000 aged persons supported, 400,000 maintained through the CCC and National Youth Movement, 200,000 farmers supported solely through relief; 1,500,000 to 3,000,000 through unemployment benefits, and 3,125,990 this past week through WPA. This combined group, some 9,000,000 payees, cares for 21,000,000 dependents in all.

That is not all. Figures received directly from the bureau of census this week show 851,000 so-called classified federal employees, 3,625,000 state employees; total some 4,500,000. There are also 250,000 in the army and navy; also 500,000 not listed anywhere,

receiving government pensions. This second group of some 5,500,000 also support, with government money, 21,000,000 more. Thus a grand total of 42,000,000 persons are dependent under our new economic alignment on government expenditures.

There are 11,000,000 unemployed. Some 6,000,000 are absorbed through WPA, unemployment insurance, and pensions. This leaves 5,000,000 actual unemployment and therefore not paying direct taxes. Thus 42,000,000 are supported by government, and 5,000,000 workers, who represent perhaps 20,000,000 people, are not the basis of any substantial tax.

The national income is estimated at 59 to 69 billion. Call it 65. The figure is high. Federal tax collections are estimated at 5 billion, 3 hundred million this year, state collections about 7 billion. Twelve billion taxes out of 65 billion income is almost 20% of national income in taxes. But, national income is duplicated. Corporations report income; then dividends are distributed; income is counted twice. Mr. Worker receives salary; this is income; he spends it; the recipient reports his collections as gross income; the figure is duplicated. It is duplicated all along the line. The tax rate is nearer 30% of the national income. *But*, we are spending $16,900,000,000 out of that high estimate of 65. We are spending, taxes and borrowing combined, 26%, ratio 17 to 65; but taking duplications into account, we are publicly spending approximately 36% of our national income!

There is no use going into details of taxes. As an example, National Association of Manufacturers report that of the sale's price of tobacco, 30% is tax; liquor, 60%; gasoline, 22%; electricity, 20%. Details of this kind would take all afternoon. But take the "small end of the horn" for a moment. Your National Consumers Tax Commission, only last week, at Chicago, found after exhaustive investigation that the average New York family earns $1470 per year, but must spend $1590, deficit $140, but pays $192. The tax element makes it impossible to live properly. It adds to the financial slavery of the average-working family.

All right, where does it lead? Half the population must support the other half. National wealth matters little. Taxes must be collected annually. Business cannot stand the ratio. We are living in a tax collector's Utopia. You have been discussing the "niceties" of taxes; commendable; but there is a bigger, broader problem; are we heading for a civilization as low as the levels of Europe? As socialistic as Russia's? Is this what is *going to happen?* Or is the situation here now? Just take borrowing; 70% of our banks' funds are in cash and government loans. Borrowing also must stop. Banks must carry cash reserves; they can't buy more bonds; oh yes, they are subscribing, but if Senator Glass is correct, they are being secretly forced to subscribe.

The government is in the housing business, utility business, farming and exporting business, banking business; well, if we keep on, the other half who have always been in business, won't be in at all. Understand, many measures passed recently are commendable—the SEC act, the Wage and Hour bill, the FHA, Federal Deposit Insurance act, etc.—but these do not call for a " pay off " of about 30% of all income, or the expenditure of 40% of all income.

When this is realized to be a fact—we are talking about today and not the future—the evil has arrived. Unemployment, yes, unemployment is here, not periodically; it is permanently here. And here largely because of our poorly-conceived taxing system. Every emergency tax quickly becomes permanent. And people want more and more relief. Business cannot carry a bigger load and, most important of all, despite temporary employment, business is getting smaller, not bigger. Who wants to start a new business of any size! Mr. Wallace says things are normal, government loans increase 20 billion (the statement should be 30), business loans drop 20. But, the entire 30 billion increase, plus 90 billions in taxes collected and spent, 1931 to 1939, create no new repeating employment, except government jobs. They do not create new sources of taxes. Some 20 billions loaned to business, even though half becomes lost, produce employment year after year, new sources of taxes. The whole theory seems wrong to me—I leave to you the answer.

What have we? After the civil war we had the bloated bondholders, but now what? We have six vested interest groups that the country and business must maintain. The veterans, almost a billion a year; expenditures for them may be desirable, but nevertheless they are expenditures; the bondholders, 65 billion in bonds out; the farmers, another billion expenses; the pensioners, another group; the permanent reliefers, certainly another vested interest; and finally, the enormous horde of officeholders, certainly a group that cannot easily be reduced.

And remember, 95% of all businesses end in bankruptcy. It doesn't take much to " tip over " the 5% that survive. The margin of gains and reserves is small. It is already tipped over; we cannot, except in war, expect business to be larger than at present. But, you say, it is all justified. True, if you agree that we should have a changed civilization, one in which the almost moronic element will run these United States. The United States that once was admired by all the world for its business efficiency, economy, progressiveness. If you want what the social security board calls an " intensified economic nationalism," all right. But you must first close your eyes to these facts.

As taxes grow, business decreases. When we reduced taxes, 1921 to 1929, business grew. There is an economic law you cannot deny. You cannot abuse, destroy, tax it out of existence, and then expect it to live. It cannot be done. It is not being done. The

situation, the result, is now here, not coming in some future era. Yes, the United States is rich; it can borrow; but it cancelled its gold obligations; it can do it again—might have to. States can borrow, but the supreme court said, in the Bekins case, municipilities can go bankrupt. This is aside from the point; current, recurrent taxes can come only from business, not from borrowing; and business cannot now pay the bill and survive. Taxable capacity cannot keep up with government expenditures. The 30 billion debt increase proves it; the annual increases prove it; the current stagnation of business proves it. The greater the tax, the lesser success business has. The law has no contravention. My answer is, the public cannot keep up with the tax collector.

The public has not earned as fast as the government has spent—cannot earn as fast as the government can spend. There is no way to fill a bottomless pit. Sanity in taxes and expenditures can be found only when the outgo is guided and limited by the income.

CHAIRMAN ZOERCHER: The next subject is the report of the committee of the National Tax Association on tax limitations and homestead exemptions, to be presented by Lent D. Upson, a member of the committee, in the absence of Chairman Thomas.

REPORT OF THE COMMITTEE ON PROPERTY TAX LIMITATION AND HOMESTEAD EXEMPTION

RAYMOND D. THOMAS, CHAIRMAN

At the Oklahoma City conference in 1935 a resolution was adopted requesting the National Tax Association to appoint a committee to study the homestead tax exemption movement and to report its findings to the next annual conference. This committee submitted at the Indianapolis conference in 1936 a preliminary report. In view of the popularity of the movement at the time, particularly in the middle west and south, and in view, further, of the detailed studies to determine the fiscal effects of homestead exemption then under way in several states, the committee in this preliminary report restricted its conclusions to pointing out individual and regional inequalities in the operation of typical homestead exemption plans, and to sounding a general note of warning against the then apparently growing popularity of the property tax limitation movement. The Indianapolis conference recommended both a continuance of the committee and an extension of the scope of its inquiry to include the abolition of the property tax and property tax limitation as a whole, of which homestead exemption is only one aspect. The membership of the committee was also increased.

The committee came to the 1937 conference in Baltimore unprepared to submit a final report. Another report of progress was

presented. Another extension of life was granted to the committee. Immediately after the Baltimore conference the committee was reconstituted. Of the present committee of twelve, six members are holdovers from 1937. We are here submitting a final report. Interim reports were presented with the thought that perhaps consideration of our assignment through a longer period, which was marked by agitation for and action on various kinds of proposals for the abandonment of the property tax and for limiting the property tax, might bring us to the preparation of a final report with clearer perspective.

But it is doubtful if these three years have cleared our perspective. There is rather widespread but inarticulate opinion favoring the elimination of the property tax. The property tax limitation controversy is still with us. The swoop of the homestead exemption movement of the past half-dozen years has intensified the conflicts of group interests and group thought involved in the controversy. Accordingly, our task of formulating final conclusions has by no means been simplified through this period of "watchful waiting."

Two objectives have guided the committee in the preparation ot this report—namely, simplicity and brevity. Omitted are statistical tables which might have been included as evidence of the effects of property tax limitation and homestead exemption. Also, we consider it inadvisable to burden this report with tabular arrangements of data showing the kinds of property tax limitation and homestead exemption plans adopted by various states, and the dates of their adoption. These materials are available from sources with which members of this conference are familiar. Moreover, we do not believe it necessary to restate the more or less patent or stock *pro* and *con* arguments on the property tax limitation and homestead exemption questions. We assume that these are generally well known. We assume, further, that there is general agreement that during the past quarter of a century, and especially during the past decade the trend in legislation has been quite positively toward the imposition of constitutional and statutory limitations on the property tax and toward an extension of the exemption from taxation of certain classes of property, particularly owner-occupied homesteads.

We interpret the resolution defining the scope of the committee's assignment, adopted at the Indianapolis conference in 1936, to call for a statement of our findings or conclusions under three main headings, to wit: (1) An appraisal of the proposal for the abolition of all taxes on property; (2) An appraisal of various proposals for the restriction or limitation of the property tax; and (3) An appraisal of the homestead tax exemption movement.

I. Abolition of the Property Tax

1. *Conclusion*

The proposal to abolish the property tax and to substitute therefor some other source or sources of revenue we believe is both undesirable and impracticable. The prospect which this proposal apparently offers for tax reduction to so large a mass of taxpayers is a decided advantage of strategy. The proposal cannot be passed up as a mere fancy of so-called "radical" tax reform advocates. The possibility that well-organized and directed campaigns may result in the adoption of the proposal is ample cause for real concern.

Few critical students of taxation would believe that the property tax can be eliminated from the local tax systems in the United States, although many may be found who would advocate the discontinuance of levying general property taxes for state purposes. Most if not all students would probably favor the modification of the property tax materially. There is, however, a lack of general agreement on the character and extent of the desired modifications. We deem it advisable, therefore, to consider briefly the pressing necessity for the retention of the property tax as the extraordinarily productive revenue means it has been, to present such rationalization or justification as can be made for this inevitable tax, and to indicate the devices by which it may be more effective and less inequitable in its application and operation.

2. *Local Dependence Upon the Property Tax*

It is a plain fact that our local governmental units — counties, cities, school districts and others—have had some, and quite costly, public services assigned to them. Another way of saying the same thing is to say that American taxpayers in each community (taxing district) have had the priceless privilege of spending their own money in their own way and for purposes of their own choice to a degree that is probably unexcelled anywhere. Under this scheme of local fiscal autonomy enormous amounts of public funds have been raised and spent. This decentralization of public services and fiscal responsibility has its drawbacks, but the net advantages are so great that the practice should be continued wherever it does not lead to fiscal chaos. Local fiscal autonomy, however, should not in practice exclude proper and locally acceptable supervision by the state over assessments and public expenditures in the interest of public economy.

Another equally plain fact is the absence of any possible substitute revenue source that is at the same time fiscally adequate and capable of local control and administration. Wealth, particularly real estate, is peculiarly tangible and measurable, and must necessarily have a *location* in a tax district. It cannot easily get away.

The aspect of *wealth* that renders it such a peculiarly suitable measure and base of local taxation is its inability to escape. Other bases or measures can and do escape far more easily, or would probably do so if they were used as a source to raise such huge amounts of revenue as flow into the local treasuries from taxes on property. The geographical distribution of tangible property is far from being equal. It is, however, more equal than any other source or measure could reasonably be expected to be. One needs but to try to allocate, say, the income tax or the general sales tax to local governments in proportion to the origin or place of collection in order to be convinced of this fact. On the revenues from these taxes, collected locally, local government could not exist.

3. *Rationalization of Property Taxation*

The property tax can be rationalized in terms of both the ability-to-pay principle and on the benefit principle, as well as on the grounds of fiscal adequacy. But the explanations will differ according to varying conceptions of taxable property. Taxable property can be regarded in three ways. State tax laws attempt to use all three of them, and for this reason the property tax is a hodge-podge. The property tax has grown in an unplanned way during a period of some 300 years, involving perennial and half-hearted attempts to patch it up to conform to changes in economic society. As a result there is confusion of ideas as to its nature and justification.

(1) *A Net Worth Tax.* Probably the most logical way to regard the property tax is to think of it as a tax on each person's net worth, the difference between his assets and his liabilities. This is the characteristic feature of that part of the property tax which applies to intangibles. With certain exceptions, debts are deductible from credits. But the tax on tangible property is not a tax on net worth. Debts are practically never deductible from tangible property.

If the entire property tax were a tax on net worth, it would be much more easily explained under the ability-to-pay principle. A person's ability to pay would tend to vary with his net worth. If the property tax were a net worth tax, it might justifiably be brought within the progressive principle, the rate increasing with the increasing amount of his net worth. This plan would go a long way toward causing the property tax to be considered as a personal tax, since the size of the payment would be directly related to the economic condition of the taxpayer. It must be said, however, that the American property tax is not a net worth tax to any appreciable extent. It is not a personal tax; it is an impersonal tax, a tax *in rem.*

We desire to point out with emphasis a serious defect in the net worth tax on property, as a result of which it is unsuited as the sole or principle revenue source in our small fiscally autonomous

tax districts, especially school districts and townships. That defect is found in its varying fiscal sufficiency or insufficiency among the various taxing districts. A person's net worth, if used as a tax measure, must necessarily have its taxable situs in the domicile of the owner. But his domicile may be anywhere; and owners of large net worth tend to concentrate in certain states or in restricted districts within each state. There are creditor states and debtor states, and creditor districts and debtor districts within the same states. Distinct debtor districts and debtor states could not live on the revenue from a tax on the net worth domiciled within their confines. In contrast, creditor states and creditor districts would be able, in effect, to tax the wealth located in other states. It is for this reason that real property and most forms of tangible personalty are now taxable, without deduction for debts, in the taxing jurisdiction in which they are located. They are taxed impersonally, without regard to the owner's net worth.

(2) *A Tax on Wealth as Such.* Taxable property can be considered as wealth owned, regardless of the owner's economic status measured in terms of net worth. This is the rule that governs the property tax on practically all tangible property. The owner, or possessor, is required to list it, without deduction for debts, and without regard to his net worth. So it happens that a taxpayer may pay taxes on many times his net worth, or he may pay on only a small fraction of his net worth. It even happens that a person or business concern having no net worth, or in fact definitely insolvent, may pay taxes on a large amount of property. The thing owned is taxed, not the person. Liens for unpaid real property taxes are generally enforced against the land rather than against the owner. The fatal defect of the net worth property tax is thus avoided in our American property tax practice. It taxes things where they are situated and employed. It does not discriminate against debtor states and debtor districts. It is not, however, as equitable as between the taxpayers as the net worth tax would be. Equity is sacrificed to fiscal necessity.

This impersonal tax on things, however, is not entirely without justification under the ability-to-pay principle. All property considered as a mass has ability to pay in the sense that in mass it produces an income out of which taxes may be paid. But the tax is not apportioned according to ability among individual taxpayers. According to the benefit theory there is justification for this impersonal tax. Tangible property receives governmental services where it is located. But the controlling factor is not the justification according to ability to pay or the benefit enjoyed. It is rather the prime necessity on the part of local governmental units for having some local source and measure of their sole or principal revenue, which is widely distributed and which cannot escape. The fact that property is taxed is well known. However, if effective stabilization

of the tax can be accomplished, buyers and sellers of property should have no difficulty in adjusting themselves to the economic reality of the property tax.

(3) *A Tax on Rights as Such.* A third logical possibility is to regard the property tax as being not on the things owned, but on the rights in things. For example, a mortgaged parcel of real estate would be taxable partly to the mortgagee and partly to the mortgagor, in proportions according to their respective interests. There are still a few states in which, for example, the taxable value of a homestead might be reduced by the amount of the mortgage, provided the mortgagor discloses the mortgagee, and the latter is taxed on his equity. There is not much to be said for this way of defining taxable property. The principal difference between the tax on rights in property and the tax on property as *wealth*, is that under the former all things taxable would be taxed to all the equity holders, in proportion to their holdings, while under the latter taxable things are taxed to the owner, however nominal his equity and regardless of his holdings. The tax on things as such involves reaching only one taxpayer for each parcel; the tax on rights involves reaching as many taxpayers as there are interest holders.

The plan of taxing rights in property would obviously aggravate the difficulties of administration. Moreover, the attempt to secure justice in property taxation by the taxation of rights rather than things as such is likely to prove futile. For, to consider but one simple example, if a mortgagee knows that he must pay the tax on his interest, he is likely to compensate himself in one of two ways. He might be able to exact a higher rate of interest or he might contract with the borrower for the latter to pay the tax on the former's interest, as well as his own. The result is the same as if the owner had paid the tax on the entire parcel himself, except that the administration would be immensely complicated, especially if this arrangement were to be extended to the taxation of all rights in things.

4. *Inherent Defects in Property Taxation*

It is clear that property taxation as the principal or sole source of local revenue fails to meet the requirements of fiscal adequacy in taxing districts which are poor in taxable property. This is least so if the property tax is a tax on *wealth* as such; that is, if the property tax is a tax *in rem* and, therefore, impersonal. Even under this form of property taxation the distribution of taxable property is unequal, relative to the needs for public expenditures. Concentration of mineral wealth, of public utility property, gerrymandering of taxing districts, smallness of taxing districts, and other factors bring about this variation in relative fiscal insufficiency. Considered from the taxpayers' point of view, this means excessive variations in tax rates for a given standard of public ser-

vices, or poorer services, or both, if the property tax is to be the sole or almost the sole support, as it has been in the past.

There is another way in which property taxation, even at its best, is fiscally insufficient. Taxes on property, like other taxes, must be paid in cash. Cash income from property varies widely from year to year for individual taxpayers, due to poor crops, personal misfortunes, and other circumstances. But the capital value resting logically at least upon anticipated income, which is the base and the measure of the tax, has no corresponding variations. It is impracticable to change assessed values to fit particular temporary property income situations. Many taxpayers, therefore, find themselves faced with taxes to pay, and no property income with which to pay taxes due. This condition is applicable not only to isolated individuals but to entire groups in depression periods. But the public treasuries must have money, sometimes more of it when the taxpayers have less of it. The effects of these defects are in part evidenced by the enormous volume of tax delinquency which characterizes business depressions, or the concentration of delinquency in economically decadent areas.

5. *Necessary Modifications of the Property Tax*

Let it be repeated that the property tax must be retained, because there is no available workable substitute for it as the principal support of local governments. We frankly recognize, however, that the property tax, like all other taxes, has defects, and that these defects become progressively more conspicuous as the amount of revenue to be raised on property increases. Hence it becomes necessary to safeguard the property owners against bearing a disproportionate part of the total tax load. It is the considered judgment of the committee that efforts to abolish the property tax should be withdrawn from this undesirable objective and directed toward the improvement of property tax policy and practice. Since this alternative raises questions which lie on the periphery of the assignment of the committee, we shall restrict our comments under this category to a brief outline of suggestions.

(1) *Improvement of administrative organization and procedure.* Much needed generally is a rather thorough overhauling of assessment and equalization machinery. The central state government is in a strong position for the improvement of equalization practices. Higher assessment standards are an imperative necessity. Effective, equitable and universal assessment of property subject to tax is a standard which we should exert strong efforts to achieve. The achievement of this standard would be a positive step toward property tax reform and, also, toward a reduction of property tax rates. Correlative improvements would include the consolidation of uneconomical taxing units, central supervision and administrative

control of local fiscal affairs, and perennially vigilant budget procedure and public-service planning.

(2) *Transfers of public functions.* Whenever public services lose their predominantly local character, they should be transferred to state and federal governments. The percentage of the total costs of government borne by the property tax would thereby be reduced. The central governments have other revenue sources that are not adaptable to local administration and use.

(3) *Broadening of fiscal support.* State and federal treasuries derive revenue from sources not available to local units. This revenue should support in part, by means of subventions and grants-in-aid or equalization funds, important and hitherto wholly local functions which have come to have a wider interest and concern, such as schools and roads. The emphasis already expressed on the necessity of the property tax as a source of support of local governments should not be interpreted to mean that we would favor unrestricted freedom of local units in spending funds received in grants from the central governments. Governmental units sharing in the creation of funds should also share in the responsibility of determining the conditions and standards governing their expenditure.

(4) *Modification of the tax base.* In the interest of administrative efficiency and of the elimination of double or multiple taxation, the property tax base should be redefined. This redefinition should be restrictive. The uniformity rule applied to the property tax operates to make the property much too inclusive. Inequitable pyramiding of the property tax results from the lumping of intangibles with tangibles in the definition of taxable property.

It is not necessary in this report to labor the point that intangibles should not be subject to property taxation along with tangibles. Reform in property taxation will probably be in the direction of the elimination from the tax base of personal effects and other consumers' goods in the hands of consumers. These have only a second-hand value, and are for that and other reasons generally poorly assessed. Their assessment is usually quite expensive and annoying. Effective and equitable administration requires the elimination from the tax base of all kinds of personalty which cannot readily be found and assessed. It is not necessary to attempt to tax every item of property. There is, we believe, an altogether too persistent prepossession in this country that uniformity and justice require the inclusion of every conceivable item of property within the property tax.

II. Property Tax Limitation

The question of property tax limitation has been bandied about in our annual conferences for a number of years. The committee comes to the statement of its conclusions on this controversial ques-

tion with the feeling that our statement will probably come far short of a model or final disposition of the limitation issue. But we are certain that our assignment requires us to make our statement of conclusions definite and clear-cut.

1. *Definition of Property Tax Limitation*

A first requisite is an understandable definition of "property tax limitation." For the purpose of stating a conclusion we have considered property tax limitation to mean the establishment of an *overall* or upper limit on the property tax rate, a ceiling rather rigidly fixed by the state in constitutional provisions or even in statutory provisions. This upper limit would operate to restrict the constituents of local governments in exercising control over the property tax as practically the sole or principal source of support of local services. Our definition excludes from *property tax limitation* the establishment by constitutional or statutory provisions of lower and upper limits between which proper local authorities can fix specific or total levies without the requirement of a vote of the people. The establishment of this zone within which ordinary budgeting procedures can operate is a practical necessity. Excluded from our definition are any workable safeguards against the creation of public debts by local administrative authorities which would constitute a lien on property by reason of revenue requirements to amortize the debts. Excluded, also, are statutory provisions safeguarding against extravagance in local government budget construction or against mismanagement or misappropriation of public funds.

2. *Conclusion*

We have approached our conclusion from the position of excluded middle ground. In terms of the limited meaning of property tax limitation as stated in the preceding paragraph and in the presence of carefully stated positions on tax limitation — pro and con — and, further, with full consideration of analyses of the effects of tax limitation in actual practice, together with consideration of tax theory, we have thought in both directions from the excluded middle toward an unequivocal affirmative position or an equally unequivocal negative position. We have arrived at an unequivocal negative position.

Our conclusion is that property tax limitation, as we have defined its meaning, is not in accord with sound tax theory and practice.

3. *A Movement of Mixed Purposes*

Advocates of property tax limitation are apparently not agreed on the choice of emphasis as to the most important end to be achieved by the movement. Some advocates emphasize the purpose

of protecting property values, particularly real estate, against confiscatory tax burdens. Others see in tax limitation an effective method of realizing desirable modifications in the whole tax scheme. A third emphasis is that of using tax limitation as a means for forcing a retrenchment in government expenditures. Still others would apparently emphasize property tax limitation as a first step toward a fundamental change in our American tax practice, probably to the extent of complete abandonment of the property tax. It is manifestly difficult to appraise a proposal for "tax reform" with motives and purposes so mixed as these.

Concerning the last purpose—the elimination of the property tax—the committee has stated its position in Part I of this report. For purposes only of clarifying our conclusion that property tax limitation, as we have defined its meaning, is not in accord with sound tax theory and practice, we could agree that each of the first three objectives is desirable, and at the same time we would advise against taking the tax limitation route toward the goals sought.

4. *The Property Tax in a Tax System*

No one would seriously propose that the property tax should be used as the sole source of support of all government services (federal, state, and local). Likewise, few persons would contend that all the costs of government should be paid from any other single source—net income tax, gross income tax, consumption taxes, severance taxes, or any other kind of tax. An exception would be the proposal of a "single tax" on net land income (economic rent), which is a tax on property in land as such. Our American experience in seeking to achieve the ideal of justice in taxation has resulted in the use of many revenue sources in a combination which we call a tax system. The larger and inclusive problem of financing government can be stated in terms of two sub-problems; namely, (1) that of determining the amount of public funds which should be raised and expended for public purposes during a given current or longer period of time, and (2) that of determining in terms of the general welfare the most satisfactory ways to provide the necessary funds. Each of these sub-problems should be approached from the positive point of view. Tax limitation smacks rather strongly of a negative approach.

We would not restrict our conclusion regarding tax limitation to the property tax. The setting up of barriers by rigid legal enactments beyond which the rate of any kind of tax cannot go, we believe would be equally as unwise as an overall limit on the property tax.

5. *Is it a Choice Between Limitation or Confiscatory Property Taxes?*

It may be that advocates of tax limitation who are hearing this report (or reading it) are interpreting the position of the committee to mean that the bars should be lifted, thus allowing the "tax spenders" to run wild and to lay upon the taxpayers unreasonable and economically unwise burdens. They may be asking the question: Have the taxpayers not learned by experience that only by rigid limitation legislation can wasteful current public expenditures be avoided, and the piling up of public debts be effectively checked?

Such an interpretation of the conclusion of the committee is incorrect. We desire to say most emphatically that we have little patience with those who are continually aligning the *tax payers* in battle against the *tax spenders*. Drawing artificial distinctions of this kind and feeding the fires of such an imaginary war, in our judgment, contributes little in a positive way to the establishment of the public service on a stable fiscal basis, or to the building of a sound tax system.

Is it, after all, a choice as between the alternatives of property tax limitation or inequitable and possibly confiscatory property taxes? Is the choice necessarily one as between property tax limitation or uncontrolled, extravagant, and wasteful public expenditures? Much of the tax limitationist literature would at least appear to imply that the choice is between the alternatives indicated. If such a choice be inescapable, the committee would without hesitation choose the tax limitation alternative. But such a choice is not necessary. Setting these two alternatives in contrast, to the exclusion of other choices, is illogical and unscientific. Reliable conclusions could not be expected to be derived from such a procedure.

6. *Control versus Limitation*

The committee desires to stress with particular emphasis the advantages of a positive approach to problems of public finance. In a democracy, government is an agency of the people. The people establish government. The should be expected constantly to assume responsibility for the control of its activities. Control by the people is an essential of primary importance in a democracy. If democratic government is to be dynamic and adaptable to varying social and economic conditions, the controls over government by the people must be flexible and, therefore, adaptable to change. In no aspect of the whole problem of government is control more important than that of taxation. *Control* in relation to public expenditures and taxes, in our judgment, is quite superior to *tax limitation*. Workable controls can accomplish the desirable results sought by tax limitation.

Limitation of space forbids a detailed discussion of the possibilities of *control* as a guiding idea in shaping tax policies and practices. We consider it unwise to resort to the method of limitation applied to the property tax or to any other tax until positive effort has been made to exhaust the remedies of control for the ills of public finance. Following are activity areas in which the instrument of control can operate: (1) The preparation of budgets; (2) The administration of budgets; (3) The authorization of new indebtedness, funded or unfunded; (4) Tax administration; (5) The balancing of the various sources of revenue within a system in the interest of social justice and economic stability; (6) Intelligent guidance of the growth of government activities in the interest of the general welfare; and (7) State agencies to serve in an advisory capacity to local governments with respect to each of the foregoing.

With the recent increase in service business activities of government has arisen a need for a new use of control in the interest of protecting taxation within its true sphere. Revenue bonds issued in connection with so-called self-liquidating projects, such as waterworks, hydroelectric plants, electric light plants, college dormitories, toll bridges, or for any other business activity of government should not carry a secondary security in the nature of a lien on tax revenues. But tax limitation is not the most desirable method for protecting the taxpayer against levies for interest and principal payments in connection with revenue bonds. By proper legislation the purely business activities of government can and should be entirely severed from the area of taxation.

III. Homestead Exemption

The preliminary report of this committee in 1936 (1) warned against hurried action by the people of any state in adopting homestead exemption, (2) expressed its belief that the acceptance of the idea of homestead exemption with its wide popular appeal might afford political rivals a convenient opportunity to offer attractive promises for further extension of the exemption in both area and value, (3) expressed doubt that homestead exemption is a sound method for encouraging home ownership, and (4) indicated the possibility of troublesome difficulties in the administration of the exemption plan.

The 1937 report by implication accepted the foregoing tentative conclusions and added (1) that homestead exemption in practice tends to cause an increase in the tax rate on the property base remaining after the exemption is applied, (2) that in operation homestead exemption results in wide differences of economic effects between owners of small homes and owners of large homes, between owners of urban homes and owners of rural homes, between areas of high percentage of home ownership and areas of low percentage

of home ownership, between areas with relatively large assessed valuation of business and industrial property and areas of limited amounts of such property.

1. *Conclusion*

Our observations on trends of the movement during the past three years and our careful consideration of the thorough studies which have been completed in several states not only confirm the tentative conclusions summarized above, but support the firm conviction of the committee that homestead exemption is unsound and that the movement should be positively resisted in the interest of building sound and stable state tax systems.

2. *Homestead Exemption and Home Ownership*

Homestead exemption advocates urge its desirability on grounds of encouraging home ownership. There is probably general agreement that home ownership should be encouraged. By and large, a family with stable income and whose employment is reasonably certain to continue in a community will likely find it desirable to own its home. Much can be said in favor of a high percentage of home ownership as a condition contributing to social, economic and political stability in a community. However, there are many and practical reasons why in a world of a mobile population families would not find it desirable to own their homes. This would be the case even for persons or families of large and stable income. For those numerous families whose incomes are inadequate, and who must, therefore, acquire their homes on the installment plan, or whose income is uncertain because of irregular employment and who may, therefore, lose their partially-paid-for homes through foreclosure, home ownership is a hazardous venture. It is a doubtful question whether government, through tax exemption, should stimulate the purchase of a home when there is no reasonable prospect of stability of income adequate to guarantee that the home will not be lost. The number of mortgage foreclosures even in prosperity, but, of course, much greater in a depression (unless moratoria and other staying devices are employed), is appalling enough to give pause to a venture to stimulate home ownership by a tax exemption premium among a class of inadequate and uncertain income.

Will tax exemption cause an increase in home ownership? The exemption plan has not been effective long enough to warrant an attempt to answer this question by objective analysis. An answer arrived at deductively must be in the affirmative, at least with respect to nominal ownership. If the exemption covers only state taxes, as is true in Texas, for example, the advantage conferred by exemption is so small that on rational considerations it should not induce any noticeable increase in home ownership. With suitable

publicity by owners and realtors, however, even this minute advantage may have some effect. But if the exemption covers all property taxes and if the local rates happen to be high, the stimulus should cause a material increase in owner-occupied homes. Methods of legal transfer of title make it relatively easy to acquire the status of a home owner. A leasehold contract may be readily transformed into a contract to purchase, and that is apparently all that is necessary to establish the status as a home owner entitled to the exemption. If suitable promotion were to exploit the exemption in order to make it the cause of a boom, the increase through the boom period might be very large.

Homestead exemption confers an advantage on *persons* and not on *property* as such; the advantage or benefit, if any, attaches to or follows the person, not the property. If we assume stable and normal conditions in the market for residence property, the benefits of tax exemption will accrue to the home owners. This condition will tend to encourage home ownership. Tax exemption would not cause a change in the *total demand for* or *supply of* housing. Exemption may, however, increase the demand for owner-occupied homes. To the extent that this is the case, the demand for tenant-occupied homes will fall.

The argument that present home owners will reap the full advantage offered by tax exemption through capitalization of the advantage, is not valid either "in the long run" or "in the short run," if the condition of the market for residence is normal or stable. But the market may be dynamic, and "in the short run" anything may happen. Should the exemption advantage be so exploited as to generate a boom, the present owner of vacant or improved property may be able to capture all of the capital value of the exemption. In the succeeding recession — a boom by its very nature generates a recession—the first generation of new homestead owners may, along with many purchasers for speculative purposes, lose heavily in having to sell their properties, or in having them foreclosed. In short, the exemption may become a factor that may be exploited for speculative purposes, with uncertain but probably bad effects upon many home owners. The committee is doubtful if the exemption is in the long run a factor of very considerable importance in encouraging home ownership. More basic economic conditions — the interest rate, the home mortgage credit system, zoning and planning of community development, insecurity of income, inequitable assessments — should be placed ahead of tax exemption in determining the trend of home ownership.

3. *Is Homestead Exemption Equitable?*

Analysis of homestead exemption leads directly and quite far into the question of shifting a fairly large portion of the costs of govern-

ment from one revenue source to another and, to some extent, from one class of taxpayers to another. Homestead exemption will take away a considerable part of the assessed value base of the property tax structure. If budgets are maintained at existing levels, one of three possible courses of action must be followed: (1) immediate upward adjustment of the assessment of the taxable property remaining after exemption, or the addition of omitted property, or both; (2) increase the rate to be levied on the assessed valuation remaining, without any material change in assessment; (3) leave both assessments and levies where they are, and replace the taxes lost through exemption, by tapping other sources. The conclusion is inescapable that homestead exemption forces consideration of the entire question of tax policies and tax administration, and the people of any state who are enthusiastic about homestead exemption should be certain that the end they seek cannot be realized, unless they are willing to go along in a revenue program which will provide the necessary replacement funds.

Studies of homestead exemption in operation show clearly the unequal effects among individual taxpayers and between different taxing districts. An exemption of, say, $1,500 affects quite unequally an owner of a homestead assessed at $500 and an owner of a homestead assessed at $1,500 or above. If the tax rate is 30 mills, one receives a benefit in tax reduction of $15, and the other of $45. Assuming that economic circumstances make it practical for a large number of home owners to own homes assessed as high as the exemption figure, the exemption law provides a benefit favorable to owners of the better homes. (This differential of advantage, however, is avoided in homestead exemption plans like those in operation in Minnesota and West Virginia.) Exemption will cause a larger reduction in the tax base in districts of high percentage of home ownership than in districts with a low percentage of home ownership. Tax districts which were strong and self-supporting before exemption became operative may be placed in a "weak district" position by reason of the exemption. This situation adds to the already confused scheme of subventions or aids from the central government.

If the revenue needs remain the same after exemption as before, it is obvious that homestead exemption tends to shift a portion of the burden of support of the public service from one group of taxpayers to another—from home owners to owners of business and industrial property, from home owners either to owners of rental residence property or to tenants. If resort is made to the replacement scheme, tax exemption may operate to shift the support of government from those most able to pay to those less able to pay.

The definition of a homestead may cause the exemption to operate quite inequitably as between individuals and groups. Is the exemp-

tion to apply only to property used as a home and occupied by the owner? Or is the exemption to apply to productive property, in addition to property in the home? We can better understand this problem when it is applied to assumed conditions. Suppose two adjoining farms, each consisting of 160 acres, are of exactly the same quality of soil, and accordingly are of equal actual and assessed value, as far as productivity of the land is concerned. Assume that the assessed value of the land, exclusive of improvements, is $3,200, or $20 per acre. Assume, further, that the owner and family of Farm No. 1 have an effective desire for a high standard of living, and that they have accordingly built a comfortable home, with other improvements in landscaping, water system, and so on. The owner and family on Farm No. 2, however, have no desires for the amenities of the home and its grounds. The assessed value of the home and its surrounding improvements on Farm No. 1, we shall assume is $1,500, and of the home and surrounding improvements on Farm No. 2 is $500. In the definition of the homestead for tax exemption shall the respective owners and families on these two farms be allowed the same exemption? If a homestead, for exemption purposes, is defined as 160 acres and in a maximum amount of $1,500, then both owners would benefit in the full amount of the exemption. But if the homestead be defined as consisting of the home occupied by the owner and the five acres constituting the homesite, then Farm No. 1 would be accorded the full $1,500 exemption, while Farm No. 2 would be exempted from taxes only in the amount of the value of the home and its surroundings, or $500 for the home and another $100 for five acres (at $20 per acre), or a total exemption of $600.

No proponent of homestead exemption favors exempting productive or income property in towns and cities, under the name of homestead exemption. There would probably be no difficulty in deciding that the urban homestead should be restricted to an area of not more than ¼ of an acre. To permit the homestead exemption to apply in the country to a large area, say 160 acres, which makes it possible for the exemption to apply to productive property and then to restrict the exemption in towns and cities to residence property only, is to legalize an unreasonable distinction, if not discrimination, between small home owners in the country and in the towns. Suppose we think of an owner of a small grocery store, in a town or city—and there are literally thousands of small-scale business and professional proprietors in any state. Assume that this groceryman lives in his own home, which is assessed for $800. He could not expect to receive the full benefit of the $1,500 exemption. His productive property, store building and stock may be assessed at $2,500, or a total valuation of $3,300, for home and business property. But his tax exemption is restricted to his home property only.

4. *Homestead Exemption and Special Privilege*

The taxing power of government should never be used to foster special privilege. Homestead exemption offers a privilege that cannot be extended to all. Any kind of special privilege is objectionable in a democracy. Home owners are likely to vote for tax exemption because it will bring to them a special privilege or benefit. Once adopted there will probably follow promises of extension of the exemption benefits in party platforms and by candidates. The time has come in this country to halt those who promise better schools, more and better highways, higher pensions to more and more people, and so on, and at the same time hold out the pledge to exempt homesteads from taxation and to reduce the unbearable tax burdens resting on the people. Home owners are the most stable citizenship in any community, and more than any other group would be expected to support sound and stable government.

5. *"Exemptionitis" a Serious Property Tax Disease*

The use of exemption from taxation for the purpose of benefiting certain classes or groups in the population or to encourage the establishment of industries is not a new practice. Ex-soldiers and ex-sailors have in most of the states been beneficiaries of tax exemption. Tax favors and exemptions have been held out as attractions to railroads and manufacturing industries. And the movement continues despite the serious doubt whether tax exemption is of any particular importance in the permanent location of industry. Tax exemption has been granted to religious and charitable and other non-profit organizations. No one can say whether another legislative act or another court decision will add other zones to this favored territory. Much needed is an acceptable definition of a "religious, charitable, or non-profit organization." Now comes a new and popular demand for exemption of homesteads in behalf of the high purpose of creating a nation of home owners. This new extension of tax exemption will cause rather serious dislocations in state and local revenue systems, and at a time when stability is much to be desired.

"Exemptionitis" is a serious ill of our real estate tax. An extension of exemption to so large a block of property as is represented in owner-occupied homes aggravates the disease. The restoration of real estate tax health requires a major operation to remove the malignant exemption tumor. The committee recommends that we move toward an *exemptionless real estate tax*. We need to destroy the exemption ills we have rather than to fly to homestead exemption and to others we now know not of.

Raymond D. Thomas, *Chairman*	R. W. Nelson
Edward P. Doyle	J. A. Scott
T. Levron Howard	Don C. Sowers
Jens P. Jensen	George G. Tunell
Melvin B. McPherson	Lent D. Upson.

A qualifying statement by George G. Tunell: "The overall tax limitation is a plan of escape from excessive taxation grown too burdensome to be borne. Public expenditures have got out of hand. Taxpayers now have only a small voice in the determination of expenditures and taxes. If it could be done safely, having in mind governmental revenue needs, I would like to see taxpayers gain control."

Edward P. Doyle of New York City, a member of the committee, is not in agreement with some of the statements in the report relating to tax limitation. Mr. Doyle does not favor a rigid overall tax limitation. He favors the limitation of governmental expenditures. He would accomplish the same purposes sought by the tax limitation movement by effective limitations on public expenditures. In other words, he believes that effective controls should be exercised over public expenditures. He would have preferred that the report be much more strongly worded on the point of limitation of public expenditures.

Herbert D. Simpson (Illinois): When is it in order to discuss this report?

Chairman Zoercher: After you are through reading your paper; then will come the discussion on all.

Come on up, Doctor. You are taking the place of Mr. Kohler. You are to read the report of the committee of the National Tax Association on capital gains.

Mr. Simpson of Northwestern University!

Mr. Simpson: Mr. Chairman, I am under considerable embarrassment in reading this report. Mr. Leland grabbed me just at the beginning of the banquet last evening, said he had a telegram from Mr. Kohler that he would not be able to be here, and asked me if I would read the report. I said I would not, because of my recent membership on the committee, and because of the fact that I am not as familiar with the report as I would like to be. Since that time I have spent considerable time on the telephone trying to locate members of the committee. As far as I can find out, there isn't a single member of this committee still here.

I would like, if I could, Mr. Chairman, to find out whether any other members of the committee are here — Mr. Paul, Mr. Cleary or Mr. Osgood?

Paul E. Farrier (Illinois): Mr. Osgood was unable to come. He asked me to contact the members of the committee in his behalf, and I had exactly the same difficulty you had, Dr. Simpson.

Mr. Simpson: I wish I could have contacted you before I came up.

Chairman Zoercher: Just go on and do what Dr. Leland wanted you to do—read the paper.

Mr. Simpson: I will take the liberty, if that is agreeable, of somewhat abbreviating and omitting some of the detailed portions of the report.

REPORT OF COMMITTEE ON TAXATION OF CAPITAL GAINS

E. L. KOHLER, CHAIRMAN

Your committee has been charged with the duty of reviewing the questions of whether capital gains should be subjected to the income tax, and if so, how. Time has not permitted a thorough canvass of all the available ideas which have contributed to the problem and its possible solutions, and it has therefore seemed best in this year's report to set forth a number of preliminary observations, with the thought that if the committee be continued another year the reactions of various authorities to our present suggestions be made the basis for further study.

At a joint meeting of this committee with the association's committee on federal taxation of corporations two months ago a number of the members present were of the opinion that the conclusions of the two committees should, if possible, point in the same direction, to the end that the association's policies on the taxation of income might be more sharply defined. It may be well that the association's ultimate contribution to the theory of income taxation will be of considerable importance, especially if the membership of the committees dealing with the subject continues to be drawn from fields of endeavor in which the various aspects of income are of immediate concern.

Status of Capital-Gains Taxation

Your committee has prepared two charts that will be reproduced with this report. The first gives a chronological history of our national taxation of capital gains; the second, the attitudes toward capital gains of 31 states having income tax laws. From these studies we may deduce the following:

First, that the definition of capital gains and losses is quite uniform and with the exception of one point has remained so for many years. That is, a capital gain or loss is the difference between the

realized selling price and cost[1] of any asset except stock-in-trade[2] and, in recent years, property subject to depreciation.[3]

Second, that almost from the beginning of income taxation, recognition has been given in some way to the peculiar character of capital gains or losses, particularly of individuals, as compared with other forms of income. This recognition is illustrated by limitations on the deduction of capital losses,[4] a flat reduced rate for taxpayers with large incomes,[5] and fractional taxation.[6]

Third, that the recent trend in the federal taxation of capital gains has been away from the flat rate to rates reflecting ability to pay.[7]

Fourth, that of the states[8] having a tax on net income, a large majority regard capital gains as ordinary income. Because most

[1] On March 1, 1913, value in the case of property owned before that date; market value of certain types of property acquired, etc.

[2] Stock-in-trade has been consistently regarded as held primarily for sale within a short period and therefore not subject to a favored rate.

[3] The cost, less resale or scrap value, of limited-life property productively employed is habitually regarded in commercial practice throughout the world as recoverable through depreciation charged as an expense against income. Any difference between the amount realized upon final disposition and depreciated cost may thus be properly treated as an adjustment increasing or decreasing current expense for depreciation previously expressed. This practice has been insisted on by the Federal Bureau of Internal Revenue for a number of years but was given its first expression in the Federal Revenue Act of 1938.

[4] Capital losses of individuals not deductible, 1913-15; deductible only to the extent of gains, 1916-17; deductible in full, 1918-23 (individuals) and 1913-1928 (corporations); deduction limited to an amount that would reduce the tax payable by not more than 12½% of the loss, 1924-32; losses from sale of stocks and bonds limited to the gains from such sales, 1932-33; losses limited to capital gains plus $2,000, 1934-37 (individuals), and 1934-38 (corporations); short-term capital losses (on assets held less than 18 months) in excess of short-term capital gains deductible only from following year's short-term gains, 1938; portion of long-term capital losses deductible (66⅔% on assets held 18-24 months; 50% on assets held longer), provided the reduction of tax payable is not more than 20% (18-24 months assets) or 15% (more than 24 months assets) of the loss, 1938. See also Table I.

[5] A maximum 12½% rate applied from 1922 to 1932 to net capital gains on the sale of assets held more than two years, but it has never applied to a taxpayer whose total income for a single year has been less than $30,000 because of the level of combined normal tax and surtax rates at that point.

[6] From 1933 to 1937, from 30% to 100% of capital gains was added to income from other sources, the percentages varying with the years held; from from 1938, 50%–100%.

[7] This is illustrated in the 1934 and 1938 revenue acts which apply a sliding scale of percentages to capital gains, varying with the time held, and impose a tax on the results at ordinary rates. At the same time a vestigial flat-rate tax persists in the percentages which fix the maximum influence of capital gains and losses on the tax.

[8] Thirty-four states at present have taxes on net income. Income from capital gains is taxed in full as ordinary income in the year of realization

state income tax rates are low, the influence of special groups of taxpayers on the form of the tax does not seem to be felt as strongly as in federal tax legislation, and the necessity for devising a means of avoiding the application of high surtax brackets of a single year has not been as great.

Objections to the Taxation of Capital Gains

Andrew Mellon has been generally credited as the leading opponent of capital gains taxation. As secretary of the treasury in 1921 he wielded a powerful influence on the congress, and without his influence it is possible that the flat tax of 12½% would never have been introduced into the revenue act. His leading arguments were that the tax unduly restricted the volume of property turnovers and reduced governmental revenues.[9]

Many other persons have argued that the capital gains tax produces an "unnatural" effect on the market. R. M. Haig pointed out in his discussion of the British tax system[10] that favoring capital gains while retaining a tax on other forms of income produces perhaps an even greater unnatural effect. Widespread practices in England, and in France and Germany also, described by Haig, are to sell stock *cum* dividend and buy it back *ex* dividend; to incorporate a foreign holding company and cause it to issue debentures exceeding in amount the assets transferred thereto, and retire them with the income derived from the transferred assets; to buy bonds at a discount and sell them at or near par just before maturity. Thus, by excluding capital gains from taxable income, a tenuous line has to be drawn to distinguish capital gains from

in the case of 28 states levying taxes on individuals and 30 states levying taxes on corporations. Three additional states have sliding-scale rates which are applied to the capital gains of individuals. Only Massachusetts applies a flat rate. See Table II.

[9] *Report of the Treasury on the State of the Finances:* fiscal years 1922 and 1923. Similar also are the arguments of L. H. Parker in *Supplemental Report on Capital Gains and Losses*, which formed a part of *Reports to the Joint Committee on Internal Revenue Taxation*, U. S. Government Printing Office, 1929, pp. 6-7; and Ellsworth C. Alvord, "Capital Gains and Undistributed Profits Taxes," *The Tax Magazine*, March, 1938, p. 145; and the statements by Representative Celler, p. 393; Henry B. Fernald, p. 527; *Revision of Revenue Laws, 1938*, Hearings before the Committee on Ways and Means, House of Representatives.

[10] Dr. Haig states: "One way to reduce or avoid the British tax is simply to buy stocks for the rise and not for the dividends. Profits from casual transactions in stocks are exempt; dividends are taxable. This inserts in the market an extraneous and artificial factor in favor of the type of investment that promises fruits in the form of exempt appreciations rather than taxable interest and dividends. . . . Those familiar with financial operations in London told the writer that issuing houses and stockbrokers in advising customers orally and by private letter frequently stress the advantages of certain securities in that they offer possibilities of profits free of tax . . ." *Wall Street Journal*, March 29, 1937, p. 4.

income, and the undesirable effects on the security market are numerous.

Studies carried out by the division of research and statistics of the treasury department [11] seem to give an effective answer to those who contend that the tax on capital gains has the effect of reducing governmental revenues. As the subcommittee on taxation states (p. 38):

> "The statistics of revenue controvert the allegation commonly made that there would be no net revenue loss over the full period of an economic cycle if capital gains should be relieved of all income taxation. Such being the case, the repeal of taxation of capital gains would not only constitute a major departure from the principle of taxation according to ability to pay but would inevitably tend to increase the tax burden upon earned income, business profits, and ordinary investment income."

A number of writers have gone much further in their attack on the tax on capital gains. Morris Tremaine argues that the capital gains tax is a major cause of booms and depressions. He states:

> ". . . we carry out a situation that brings on violent inflation and high prices because there are few sellers, and when depressed times come, there are no buyers and lots of sellers. This situation, probably caused by this tax, gave the United States the most extreme punishment of any country in the world when the depression came on." [12]

Mr. Tremaine overlooks the fact that in boom times it is primarily the speculator who is realizing capital gains. In the hands of speculators these gains can only aggravate market conditions, since they will almost certainly be used further to inflate the security market. Even "unwise" investments by government would be preferable to this course, for the money would be retired from the security markets and placed where it would help to improve the general price structure.

[11] *Revision of Revenue Laws, 1938.* Hearings before the Committee on Ways and Means, House of Representatives, Seventy-fifth Congress, Third Session, U. S. Government Printing Office, pp. 36-54, 81-84, 112-123. Washington, D. C.

[12] "The Capital Gains Tax," *The Tax Magazine*, September, 1937, p. 517. This argument is duplicated by Irving Fisher. "Moreover, tax-dodgers who thus sell during a fall of prices, thereby tend to increase the fall. Likewise, when they buy during a rise, they tend to increase the rise; so that among other faults of the present system (of taxing income, particularly capital gains) is its tendency to intensify both booms and depressions." "A Practical Schedule for an Income Tax," *The Tax Magazine*, July, 1937.

Criteria of a Capital Gains Tax

As previously stated, the recent trend of federal taxation of capital gains is to recognize ability to pay as the foremost factor. The 1938 report of the subcommittee on taxation to the committee on ways and means states:

> "From the standpoint of taxation, the kind of income that is relevant and significant is the income that measures taxpaying ability."

Notwithstanding the clear recognition of this principle, the subcommittee permitted several other considerations to influence the drafting of the revenue act now in force. A compromise was made in order to eliminate the highest surtax brackets and thus encourage liquidation of overpriced securities. More liberal deductions of capital losses were added to encourage risk-taking in new ventures and a distinction was drawn between short- and long-term gains in order to discourage speculation. The presence of many objectives, each, if retained, deserving a different emphasis under varying economic conditions, gives an unfortunate aspect of impermanence to the capital-gains provisions of the 1938 act and may well have the effect of discouraging turnovers of property. The adoption of a simpler scheme of capital-gains taxation, especially one based on a fixed policy as to computation and on permanently established rates of tax as to the greater portion of long-term gains, would allay a good deal of the present fear that the immediate disposition of property might be unwise.

The bugbear of the realization principle is present in all forms of income taxation, but it is probably more pronounced in the taxation of capital gains and losses than elsewhere. Many attempts have been made to solve this difficulty by various averaging devices. Some of the major proposals are as follows: [13]

1. Allow the taxpayer to report any accrued gain he wants, the gain on realization being correspondingly lessened; but do not allow him to report any accrued loss. In other respects the gain and loss would be treated as other income.
2. Use a single step-scale plan as in the revenue act of 1936 with no limitations on loss deductibility. The loss percentages should go up rather than down when there is a *net* realized loss.
3. Use an apportionment plan whereby gains (or losses) are distributed in equal parts over years of accrual, upon realization—divide the gain (or loss) by the number of years the asset has been held, place the resulting average on top of the ordinary income of the year of realization and thus get a bracket tax rate to apply to the entire gain (or tax credit on account of

[13] Summarized from an unpublished manuscript prepared by Carl Shoup with the collaboration of William Vickrey.

the entire loss). A simplified apportionment plan is to divide each gain or loss by the number of years held and adding the results to obtain a total net gain or loss attributable to the current year. The gains and losses realized are then added algebraically and the former sum subtracted from the latter to obtain the balance attributable to previous years. This plan can be further modified by actually opening returns of past years and adding this figure to the actual income for these years and the tax recomputed. Another variation would be to average the gains and apportion them to income of future years.

4. Use a series of step-scale plans with one table, e. g., arrange one step-scale for those in the $5,000 to $6,000 bracket, another scale for those in the $6,000–$7,000 bracket, etc.
5. Modify the one-table plan so that it applies only to gains and losses on assets held for more than two years (other gains and losses to be treated as ordinary income); otherwise ignore the time element and substitute the size of the capital gain or loss as the important variable.
6. Use a step-scale plan with three variables, length of time held, size of other income, and the absolute size of the gain or loss.
7. Treat capital gains and losses as ordinary income, but average all ordinary income over a period of years.
8. Bring gains and losses to account as they accrue by some form of annual inventorying.

These eight suggestions cover most of the major proposals that have been made. H. C. Simons [14] advocates the use of a five-year period at the end of which each person would average his annual taxable income and recompute his taxes on the basis of this average income. If the taxpayer discovers that the amount is less than the total of his five actual payments by more than 10% he would claim a rebate for the excess over 10%. This proposal merits consideration, but it would be difficult to initiate and confusion would be caused by the uncertainty of governmental revenues over so long a period.

Another possible solution, advocated by L. H. Parker,[15] and recently adopted by the New York Legislature,[16] is to tax capital gain and losses apart from other income at graduated rates approximating one-half the rates on ordinary income. This method seems to compromise the ability principle needlessly to achieve benefits which could have been obtained more easily and with less sacrifice by some of the proposals suggested above.

[14] *Personal Income Taxation*, p. 154.

[15] "Capital Gains and Losses," *The Tax Magazine*, October, 1936, p. 605.

[16] *The Bulletin of the National Tax Association*, Vol. XXIII, No. 9, June, 1938, p. 267.

A Proposed Solution

The committee is a unit in believing that capital gains are income. This belief arises, not from theoretical considerations, but because the layman thinks they are.[17] The enhancement of economic position which to the layman is the determinant of income arises not only from interest, rent, and salaries but also from selling property at more than its cost.

Also in general agreement are the members of the committee on the desirability of taxing capital gains whether received by individuals or corporations. The point on which no decided opinion has as yet developed is the method by which capital gains should be taxed. Most income is taxed in the year it accrues which coincides with the year of realization; but gains from the sale of capital assets, though realized in one year, may have accrued over a period of several or many years. The principle of ability to pay is not violated when capital gains are treated as ordinary income in the year of realization, for not more than the profit portion of the sum realized—and this compares with *all* the salaries, rent, and interest received—is called income: rather, the issue is one of equity, raised by the accrual of capital gains over more than one taxable period and their subjection to tax at progressive rates. The committee believes that this issue is of sufficient importance to warrant the establishing of some sort of averaging device.

The point at issue is neither the question whether income exists from capital gains, nor the question of ability to pay; it is the question of giving legal and administrative recognition to the period of accrual. The committee proposes, for discussion, another method of achieving this end. This plan, which combines a number of the features of averaging previously described, relates to individuals only:

1. Set up an arbitrary limit to the number of years for which a gain may be regarded as accruing in order to simplify the administration of the tax and because no substantial benefits will

[17] It is of interest here to recall the remark of Justice Holmes in his dissenting opinion in *Eisner* v. *Macomber* (252 U. S. 219 (1920):

> ". . . . the word 'incomes' in the sixteenth amendment should be read in 'a sense most obvious to the common understanding at the time of its adoption.' . . . For it was for public adoption that it was proposed. . . . The known purpose of this amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest."

Judge Learned Hand in *U. S.* v. *Oregon-Washington R. R. & Nav. Co.* (251 Fed. (2nd) 212 (1918) also said:

> ". . . the meaning of that word is not to be found in its bare etamological derivation. Its meaning is rather to be gathered from the implicit assumptions of its use in common speech."

inure to the taxpayer by permitting him to prorate his gains for a longer period. This maximum period would seem to be five years.

2. Require the taxpayer to divide his capital gains into not more than five classes corresponding to the number of years he held the property, all holdings of five years or more being grouped in the fifth class.
3. Divide the gains falling into each class by the number of years held, the gains in the fifth class being divided by five. The sum of all the quotients would be the capital gains of the current year; the sum of the quotients, excepting that of the first class, would constitute the capital gains of the next preceding year and so on until in the fourth preceding year only the net gains of class five would be included.
4. Each of these sums would be added to the taxable income of the related year and the additional tax would be computed in the same manner as an additional assessment is computed in case further income is discovered, the tax rates applicable to each of the five years being employed.
5. The tax payable for the current year would be the sum of all these computations, no interest being charged for the additional assessments of prior years.
6. The additional income for prior years would be added to any income previously determined, including all or part of the capital gains of that year and the part of the capital gains in succeeding years by which such income has previously been adjusted.
7. Losses would be permitted to reduce the income of the current and preceding four years and the tax also. Any capital net loss not thus absorbed would be carried into the succeeding year and, if the loss is not absorbed, the process would be continued, the carry-over privilege being extended as far as, say, a three-year period.

This scheme has the advantage of simplicity both to taxpayers and administrators—the five-year maximum is put in so that revenue officials can keep a running list without going to the trouble of opening returns. It accords with the principle of ability inherent in a progressive income-tax structure and makes adequate allowance for the treatment of gains which have accrued over a period of years. It escapes the difficulty involved in so many averaging schemes by levying the tax at a time when the taxpayer's ability is in liquid form, and gives equal treatment to people in like circumstances.

Additional points on which no conclusions of the committee have as yet been reached—points which are more or less directly related to the subject of capital gains — are (1) the taxation of gifts and

TABLE I

CAPITAL GAINS AND LOSSES (OF INDIVIDUALS) IN FEDERAL INCOME TAX LAWS

(Adapted from *Revision of Revenue Laws*, 1938, pp. 112-114)

EFFECTIVE YEARS	CAPITAL NET GAINS	CAPITAL NET LOSSES
1913–15	Taxed as ordinary income.	No capital loss deductible.
1916–17		Not deductible.
1918–21		Deductible in full.
1922–23	If held under two years, taxed as ordinary income; over two years, maximum tax limited to 12½%.	Deductible in full; except if held under 2 years. No "netting" was permitted, a capital loss being deductible only from income other than capital gains.
1924–31		Deductible in full, except if held over 2 years, limited in effect on tax to 12½%.
1932–33		Deductible, unless from stocks or bonds held under 2 years (a carry-forward provision was repealed). If held over 2 years, any capital net loss limited in effect on tax to 12½%.
1934–37	100% taxed as ordinary income if held less than one year; 80%, 1-2 years; 60%, 2-5 years; 40%, 5-10 years; 30%, over 10 years.	Deductible in an amount limited by percentages shown opposite, plus $2,000.
1938	100% taxed as ordinary income if held less than 18 months; 66⅔% 18-24 months; (maximum tax, 20%); 50%, over 24 months (maximum tax, 15%).	Deductible if held less than 18 months, with carry-forward for one year. If held over 18 months, percentages shown opposite apply, the effect on the tax being *minimum* rather than maximum; no carry-forward.

NOTE: Corporations until 1932 were taxed in full on their capital gains and allowed to deduct all their capital losses; in that year and 1933 the limitation on stocks and bonds applied. From 1934, capital net losses have been limited to $2,000.

TABLE II

STATUS OF TAXATION OF CAPITAL GAINS IN THE STATES

Compiled from replies to Questionnaires (Midsummer 1938)

State	Individuals				Corporations			Methods of tax	
	Law specifically		Regulations require inclusion	No income tax on individuals	Law specifically		No income tax on corporations	Treated as ordinary income when realized	Other methods
	Taxes	Exempts			Taxes	Exempts			
Alabama			x		x			x	
Arizona	x				x			x	
Arkansas	x				x			x	
California	x				x				U. S. 1936
Colorado [1]	x				x			x	
Connecticut				x	x			x [2]	
Delaware	x						x	x	
Georgia	x				x			x	
Idaho	x				x			x	
Iowa		x				x			
Kansas	x				x				U. S. 1936
Kentucky	x				x			x [3]	
Louisiana	x				x			x	
Maryland	x				x			x	
Massachusetts	x				x				Flat 3%
Minnesota			x		x			x	
Mississippi	x				x			x	
Missouri	x				x			x	
Montana	x				x			x	
New Mexico	x				x			x	

TABLE II—(*Continued*)

State	Individuals: Law specifically Taxes	Individuals: Law specifically Exempts	Individuals: Regulations require inclusion	Individuals: No income tax on individuals	Corporations: Law specifically Taxes	Corporations: Law specifically Exempts	Corporations: No income tax on corporations	Methods of tax: Treated as ordinary income when realized	Methods of tax: Other methods
New York	x				x				½ rates
North Carolina	x				x			x	
North Dakota	x				x			x	
Oklahoma	x				x			x	
Oregon	x				x			x	
Pennsylvania				x	x			x [2]	
South Carolina			x		x			x	
South Dakota		x				x			
Tennessee				x	x			x	
Utah	x				x			x	
Vermont		x			x			x [2]	
Virginia	x				x			x	
West Virginia	x						x	x	
Wisconsin	x				x			x [4]	
	25	3	3	3	30	2	2	28	4

[1] Questionnaire not answered. Data taken from Commerce Clearing House Service, 1938.

[2] Corporations only.

[3] Gains on assets held more than two years not taxable.

[4] Capital gains treated as ordinary income except when subject to surtax for old-age assistance, etc., they are then treated as in the 1936 act.

inheritances and of unrealized increments in property values upon transfer by the owner or at his death, and (2) the taxation of corporate undistributed profits (if that tax is to be continued) in such a way as to eliminate or reduce the tax on what are now regarded as capital gains. These are questions on which this committee's successor might profitably devote a share of its activities.

Respectfully submitted,

E. L. Kohler, *Chairman*
Randolph E. Paul
George E. Cleary
* Roy C. Osgood
Mabel Newcomer
Carl S. Shoup
Roger J. Traynor
Robert C. Brown
Herbert D. Simpson
A. H. Littleton
Martin Saxe

Chairman Zoercher: Now the time is open for discussion. Give your name.

C. C. Brown (Oklahoma): Mr. Chairman, I would like to talk just a few minutes—you will have to stop me—on Mr. Hall's and Mr. Giblin's papers. Here is what I have in mind.

In my office I have a motto so that the citizens of Oklahoma may read when they come in. It reads to this effect: "A free people, responsible for their own government, should know where the tax money comes from and what is done with it." Then I have another one to this effect, "Truth is great only to the extent that it is understood."

Now today and other days here, I have heard about the debt of state and local government. They approximately agree. Anyway, it is several billions of dollars. Today, for this discussion, we will assume that the debt of state and local government is $19,000,000,000. I think that was the figure that Mr. Giblin used.

With the exception of Oklahoma and possibly a few other states—I fail to remember any that have a constitution which permits them to go in debt without a bond issue—all of that $19,000,000,000 of debt has occurred in one of two ways: either by bonds voted by the people, the taxpayers themselves, or approved by the legislatures. I want you tax administrators to tell me if I am wrong in my assumption that the various members of the legislature of the state of Oklahoma are the direct agents of the people and the taxpayers of that state, just as much as the employees of a corporation are the agents of that corporation, and that the citizens of Oklahoma, or any other state, are responsible for every action of the legislature.

So that the taxpayers themselves, in these 48 states, with a very, very few exceptions, are responsible, the taxpayers as citizens, for all of the $19,000,000,000.

* Mr. Osgood did not approve all of the committee's findings.—E. L. K.

I have only been a tax administrator for a short time. I don't know nor claim to know anything about taxes. I have a bunch of men down there that do. I have put all my life in industry up to the last few years. I want you people, though, if you will, to go home and try and do the same thing that I have been trying to do. Talk to your chambers of commerce and your civic clubs and other interested groups, and tell them about your state.

I am criticized as a tax administrator for spending too much money, and as long as I am tax administrator I will be criticized for spending too much money, perhaps, in the administration of the tax commission because I am going to have a research department as long as I am there. I am going to put out the information where every citizen, every taxpayer of the state of Oklahoma can, if he so desires, know what is going on. I realize very few of them will avail themselves of that opportunity. However, it is taking a nice sum. That information is sent out to all of the papers, to all of the attorneys, and to all of the larger corporations.

It is true in my state the only papers that print it and comment on it in its entirety are the rural papers, and most of the information that goes to the five large daily papers of state-wide circulation is never used except when they pick out the things that we have decided are wrong. Then they write a headline across the top of the paper telling the public about the waste of the Oklahoma Tax Commission and condemning all state government just because we told them the truth about all of it.

Now, where is this state debt? Most all of it is local government, that is, a great proportion, except as the states have voted bonds for highway purposes in some states. We don't have any. Most of it is local government.

Spent how? On a vote of the people. I will tell you how it was spent. In the periods of prosperity, if those periods are when everyone who wants to and can work is working, and when industry is running way above its normal capacity, the chambers of commerce and the civic clubs, and other groups of citizens and taxpayers, meet over the state, and the chairman of the committee on public improvements in every one of these 180,000 branches of local government, get up and report that they need a new court-house, a new school-house, and so forth. Everybody is making money, so everybody says, "Aye." They don't pass a hat and take up a collection. No, they go out, and the newspapers that criticize all government today, and everybody else, and say, "we have got to carry this bond issue," and we carry the bond issue.

Well, a lot of people think we only do that for one purpose. A lot of people believe that we do that so that we will have some bonds to pay for in the next period of depression. But that isn't the only reason we do it. We have another reason, a more deadly reason, and one of the things that have contributed to more of our

trouble in this country than any other thing I can think of. That is, because at that particular time during the period of prosperity, industry as we know it—the manufacturing, fabricating industry—is running above its normal capacity. That is the reason we have the period of prosperity. Then all of these 180,000 branches of local government vote bonds, cause the fabricating and manufacturing industry to over-expand at a time when they don't need the business. They hire a lot of new people, build a lot of new plant facilities that they don't need after that is finished. They don't need them unless one thing happens, that is, unless some new industry comes in and takes up that idle plant capacity. Then, after we have done that, and as soon as the government has fabricated these buildings, then we have got a man-made depression.

My state isn't good as an example because we don't have much debt, but take your net per-capita debt curve of state and local government from the day of statehood to the present time, and you will find ups and downs. Step up twelve months and you will have a curve that shows you every period of prosperity and every depth of depression just as much as does your debt curve.

I thank you.

E. P. Doyle (New York): I just want to say a word. When the executive committee voted to continue, last year, the committee on tax limitation, I said to Dr. Thomas that I could easily raise the money for the committee to go around to the various states—to Indiana, to Ohio, where they had tax limitation, and West Virginia, New York and Louisiana, where they had homestead exemption. I didn't hear from him again until October 8, when he sent me what he called a suggested draft and told me to meet the committee here in Detroit because we had to make a report on the 28th. I went all over this and found only one place where I wanted an amendment, that was on the eighth page where it says, "Our conclusion is that property tax limitation is not in accord with sound tax theory." I wrote and asked him to put in the word "overall."

The only place I found, that tax limitation was wrong, was where it included everything, bond issues and everything else. In our state we have tax limitation, you know, but of course the amortization and payment of interest is all outside of it.

I don't want to go on record as approving this report. I am in favor of everything else in it except the conclusion concerning tax limitation.

For just a minute I want to tell you what tax limitation has done for New York State.

While Cleveland, Hill and Flower were governors, a period before 1900 when the state had nine million people, I was chief engineer of the conservation commission. Really I was a sort of handyman. I had to deal with the making of the budget. We had nine million people in the state and we ran the state on from $11,-

000,000 to $15,000,000 a year, and we only had a $7,000,000 debt. We had an American idea of government, that it was the duty of people to support the government, not for the government to support the people; that the true function of government was to protect a man in the pursuit of his ordinary occupation, and that was practically the main function of government.

It wasn't until we got the patriarchal system of government, which is that government should support the people, beginning with Smith, Roosevelt and Lehman, that we began spending money. Now with only twelve millions of people, we have a budget of $400,000,000 and a debt of $561,000,000. There are only three million more people but there is no tax limitation in the state.

In the city of New York we have a tax limitation of 2 per cent. It has worked so well it has again been put in the new constitution and, in addition, it has been made applicable all over the state in the new constitution if it is approved in the election.

In 1900, about the same time we had consolidation in New York, on the theory that we were going to reduce expenses, the budget was $98,000,000. I was supervisor over my town at that time—one of the towns that came into New York.

Forty years have elapsed. There is no tax limitation in the state and the budget has increased 27 times. The city of New York, with the same kind of an administration, with the same kind of a belief in the patriarchal system of government, with tax limitation, the city's population has doubled but the budget has only increased six times. The budget then was $100,000,000. Now it is $600,-000,000.

If we had not had tax limitation, God knows what would have happened to the city of New York.

F. S. Edmonds (Pennsylvania): On the four excellent subjects of this afternoon, I would like to have seven minutes.

Under the application of the Indiana plan, I merely want to say first to the gentleman from Oklahoma—this isn't in my time—I received the reports of the Oklahoma Tax Commission and I congratulate that commission on issuing a series of intelligent studies of the fiscal condition of the state. I hope sincerely that they do not get discouraged in that kind of work.

Now, I want to say something about two subjects on the afternoon's program, public expenditures and taxable capacity, on which Mr. Giblin gave us an invaluable series of statistics. But there is just one little phase of it I confess has been worrying me and which I want to suggest as a subject for study.

Take inheritance taxes. In the larger states they are paid out of capital. They are paid to government and used for current expenditures. In the United States I anticipate probably $600,000,000 this year; in England, which has a fiscal scheme somewhat like our

own, $400,000,000 to $500,000,000 a year. Frankly, if they once are taken out of capital and used for current expenditures, they are not there to be taxed again.

I am wondering whether or not the situation with reference to inheritance taxes is not going to result inevitably in a decreasing line of returns from inheritance taxes, and with that decreasing line, a diminution in the capital that is available for free investment in the country, which is the capital that eventually must take up unemployment?

Now, five minutes more to discuss the report of the committee on capital gains. I don't wholly agree with the report of that committe that the average man considers capital gain as income. I do not think the committee has consulted any average man in our jurisdiction. My feeling is that there is no phase of the income tax which has caused more irritation, more dissatisfaction and more unhappiness to the taxpayer than the policy of the United States in attempting to tax capital gains as income. It is not done, of course, in England. It is not done in other states which have used the income tax, but with us, the prospect seems to be that wherever there is a capital gain, it is to be put in as income and taxed at income tax rates.

I was interested to find out how that works as a tax. I wrote to my friend, Lovell Parker, whom many of you know as the secretary for many years of the joint committee on revenue at Washington. He is probably the best informed man on the subject of federal tax statistics that we have, although unhappily for the government he has recently left its service.

Mr. Parker tells me that by having a tax on capital gains as a part of the income tax, the government in 1930 lost $15,000,000; in 1931, $89,000,000; in 1932, $69,000,000; in 1933, made $16,000,000; in 1934, made $17,000,000; in 1935, made $85,000,000.

In other words, in the last six years the government lost $180,000,000 from the tax on capital gains, and made $120,000,000.

Is that a tax? It was a loss to the government of $60,000,000, and it was a loss to the government at a time when it needed money, and it was a loss to the government at a time when they needed money so badly that they had to develop new, strange, perhaps illegitimate methods of taxation in order to make up for that loss.

Now, I am not saying that there isn't a place in the fiscal system for a tax on capital gains. I am saying that to tax capital gains as a part of the income tax is, in my judgment, at variance with the mental logic of the American people. I am saying that it has caused more disputes that have gotten into court than any other phase of the income tax; that it has caused among those who believe that the government is unfair in its enforcement of the income tax,

more bitterness than any other phase of the tax. And now it turns out that in the last six years it has cost the government $60,000,000.

It would seem to me that even in Indiana, where they match these small points with assiduous care, if they had a tax which cost the government $60,000,000 in six years, or $10,000,000 a year, it might suggest that as a tax it was a failure. And if the same thing is happening with the United States government, it seems to me the same conclusion should be drawn.

Chairman Zoercher: Will you pardon me? I just want to take a few minutes.

In the state of Indiana our constitution forbids the incurring of any indebtedness as far as the state is concerned. As far as the municipalities are concerned, they can incur an indebtedness of 2 per cent of their assessed valuation, and now, under the law adopted in 1937, before any bonds can be issued, there must be a petition signed by at least fifty freeholders, and then if fifty-one freeholders sign a remonstrance against it, it stops the whole business for a year. If two hundred petitioners sign in favor of a bond issue and two hundred and one file remonstrance against it, that stops it for a year.

So you see, as fai as that is concerned, it is in the hands of the taxpayers in the state of Indiana.

Our law further provides that the budget levy and rate shall be the only budget levy and rate under which taxes shall be levied, collected and expended. The only exception is in the case of a fire, flood, war, pestilence or other major disaster.

We had in the special limitation law of 1932 a clause providing, if an emergency arose and more money was needed, then the local officials would have to adopt a resolution. Then it was referred automatically to our board and we had a hearing locally. But the court held that when the local officers declared the emergency, why the emergency existed and nobody else had anything to say about it as far as that was concerned, unless ten or more taxpayers appealed to us, and we finally passed on it.

But the legislature wrote into the law just when the emergency existed. I see the president of the Indiana Farm Bureau in this audience, and it was through the activity of the farm bureau and the taxpayers' association that some of those limitations were put in the law.

You folks might laughingly talk about the Indiana plan of controlling expenditures. I want to say to you that we have had it since 1919 and it is stronger and more effective now than it was then. Do you think the people in the state of Indiana would stand for a law that warn't of some service to them? In the fifteen years, or since the law has been in effect, as far as our board is concerned, the actual saving has been $80,000,000. That is a direct saving. An indirect saving might be more.

Dr. Leland, I want you to excuse me now. I have to finish that talk on the radio. I didn't know I was going to be on the air today but they just rang up a little while ago, so will you take charge of the meeting?

President Leland, presiding.

Chairman Leland: We are ready for discussion.

Mr. Farrier: I merely want to read a letter which has escaped the attention of the committee on capital gains. I might preface it a little by saying that Mr. Osgood, a member of the committee, received a tentative report.

I should like to read to you Mr. Osgood's letter to Mr. Kohler concerning this tentative report.

"Mr. E. L. Kohler, October 17, 1938.
Fountain City,
Tennessee.

Dear Mr. Kohler:

Upon a careful reading of the draft of the report of our committee, I find there are many implications contained therein with which I am unable to agree. While I recognize that the report must, of necessity, reflect the viewpoint of the majority of the committee, I feel constrained to point out some of the statements in the report which, to me, are at least doubtful.

In connection with the third conclusion on page two (and also the first sentence of the new paragraph on page five), might it not be said that the revenue act of 1938 is in a measure a reversal of the trend away from taxing capital gains at a flat rate? This would certainly seem to be the case if we mean by "flat rate" a procedure similar to that existing in the federal law prior to 1934. Of course, an individual's capital gains were never taxed at an absolutely flat rate. Rather, a limit to the application of the surtax rates made the use of the flat rate optional in certain cases. Also, might not the trend you speak of be attributable to the desire for more revenue rather than a recognition of the "ability to pay" principle?

The comment on page four relating to Haig's description of foreign practices is to a certain extent misleading. It is true that such undesirable practices exist, but is it necessary to "burn down the house to kill the rats"? Capital gains of the normal sort might very well be excluded from taxable income with legislation designed to make sure that capital gains were of the normal kind. Certainly we have an analogy in our own law in connection with the treatment of "wash sales" and foreign personal holding companies.

It is a little difficult to follow the comments on Mr. Tremaine's argument at the top of page five. Are not the assumptions in both

the first and second sentences based upon opinion rather than fact? Certainly the last sentence is an opinion and one not entirely free from bias.

The characterization of the treatment of capital gains in the 1938 revenue act as a 'bad compromise' is to me unfortunate. The attempt at economic objectives such as encouraging 'liquidation of overpriced securities' and encouraging 'risk-taking in new ventures' can hardly be termed a 'bad' compromise in a taxing statute. Certainly, when a taxing statute interferes with normal business transactions, as did the revenue act of 1934, it is time for a few compromises.

I question the statement regarding the arrangement recently adopted by the New York legislature. It is stated that the benefits involved could have been more easily obtained by some of the proposals previously suggested. In view of the complexity of the previous proposals is "easily" quite the proper word?

Is not the statement on page eight that the committee is a unit in believing that capital gains are income a little presumptive? Income, at least for tax purposes, is, within limits, whatever the law says it is. The question seems to me to be not whether capital gains are income but rather whether they should be taxed as income. Certainly the layman's concept of income is not the determining factor as witness the treatment of many taxable exchanges and even the determination of corporate taxable income, neither of which is completely in accord with the layman's concept of income.

Similarly, on page eight, the statement that the committee is in general agreement on the desirability of taxing capital gains is somewhat misleading. While we may recognize the practical necessity of taxing such gains at the present time, can it be said that the committee is in "general agreement" on the desirability of such practice? Personally, I cannot concede the desirability.

The entire tone of the report presupposes that capital gains are just like other income. While it might be conceded that such gains are income, if the law says so, they certainly are not like other income and should not necessarily be taxed like other income. Even supposing such gains should receive a treatment similar to other income, the method finally suggested in the report is subject to the same criticism as the method used in the revenue act of 1934. That is because of the application of the higher surtax rates there would be a natural interference with normal business transactions. Actually, the proposed plan helps only the small taxpayer who has little other income and realizes a large taxable gain in one year. In other words, the plan would reduce the tax on windfalls and penalize the normal legitimate business transaction.

Most capital gains are probably realized by persons with consistently moderate incomes. The proposal is of no help to these persons because the tax is practically the same whether it is added

to the top bracket of one year or spread over the top bracket of each of five years.

Most capital gains are probably realized by persons with consistently moderate incomes. The proposal is of no help to these persons because the tax is practically the same whether it is added to the top bracket of one year or spread over the top bracket of each of five years.

For example, suppose A has a regular income of \$4,000 and B has a regular income of \$500,000, and each realizes a \$50,000 capital gain on an asset held five years or more. A would pay surtaxes of \$1,500 while B would pay surtaxes of \$35,000 under the proposed plan. B's surtax would be the same if the entire gain were taxed in one year while A would pay \$7,700 in surtaxes if the gain were taxed all in one year. Thus, A saves \$6,200 while B saves nothing. Is this equity?

Obviously, the plan sacrifices economic considerations for a theoretical but non-existent equity. It would be practical only so long as the surtax rates were low enough to make the tax question relatively insignificant in connection with the realization or non-realization of capital gains. Certainly, with the present high surtax rates the plan is of doubtful merit. The question is whether normal economic forces and legitimate business transactions shall be sacrificed to recognize a theoretical ability to pay. Would it not be more practical to recognize this theoretical "ability to pay" principle only to the extent that it does not create abnormal conditions?

One further comment. If the question of the application of the income tax to gifts and inheritances is to be considered at all it should be co-ordinated with gift and estate tax questions. This would seem to require a considerably broader scope than that of the present committee.

Obviously, my comments reflect my personal viewpoint, but I would be reluctant to have the association, which is known for its unbiased and scientific approach, to tax questions, accept the report in its present form.

Sincerely yours,

R. C. OSGOOD."

MR. SIMPSON: I would just like to have the privilege of presenting a minority report to the report of the committee on tax limitations. I was a member of this committee on tax limitations until the report reached an interesting stage and then I was kicked off the committee. President Leland spoke of it as a promotion from the committee on tax limitations to the committee on capital gains. I have known of similar promotions elsewhere. (Laughter)

Now, I will agree with all my academic brethren that on theoretical grounds tax limitation has no place in a state constitution. It is not the kind of thing that ought to be imbedded in fundamental

law. Any freshman student in a law school knows that. But I think we are confronting conditions where even theoretical and traditional considerations may have to take secondary position. I will say more about that just in a second.

Meanwhile, I didn't understand that this report really did formulate the fundamental theoretical grounds against tax limitation. All that talk about tax limitation aligning taxpayers against government officials and feeding the fires of class hatred, I don't think has any place in a report of a committee of our National Tax Association. That isn't either economics or taxation. This isn't a matter of fanning the flames of class hatred or of building up alignments of taxpayers against government officials. I object to that paragraph in the majority report.

I am reading the minority report.

Now, the conditions which I think have changed the setting of this problem are many, but I will mention just two. The first is the fact that the federal government has absorbed so largely potential sources of any additional state and local revenue. And the second is the fact that many of our states are still bound by limitations and restrictions which prevent the development of more equitable forms of taxation.

The consequence is going to be that all of this enormous structure of public expenditure which we are facing in the case of state and local governments—particularly local governments—is going to be pyramided on this property tax base.

Now, that is what we are confronting and I don't care what the constitutional law about it in the law schools is. We are confronting a condition where an enormous pyramid of additional expense is going to be built right up on top of the high level of our present property tax system.

That is going to mean that property ownership is going to become a more and more hazardous status, and if this thing keeps on, we are going to reach the place where all property ownership is going to get over into this speculative class that we have been denouncing in connection with capital gains and other fields of taxation.

Under those conditions, I want to recommend a minority report which would take this position, that under these actual conditions we ought to recognize the reason for this, of providing some degree of protection and assurance for ordinary property ownership. We don't need to demand it, we don't need to argue for 1 per cent of 15 mills, but I think a committee of the National Tax Association ought, in view of actual conditions, to recognize at least the reasonableness of providing some assurance for property ownership in this country.

In the second place, these conditions we are facing are going to bring the property tax into such disrepute that we are going to have recurrent breakdowns of tax collections such as we had for the last

five years. Our property taxes are going to get to a place where tax resistance will become a recurrent phenomenon of tax collections in this country.

And then we are going to have a growth of all these radical movements: the homestead exemption movement itself and movements for exemption of farm properties such as we have in western states now, and then movements for exemption of this and that.

Now, the kind of property tax structure we are building up is just the thing that invites the growth of all these radical efforts to get out from under the tax in some indirect way.

Consequently, in the interest of some assurance for property ownership, and in the interest still more of maintaining, of protecting a sound and rational system of property taxation in local governments in this country, I think we ought to recognize the reasonableness and necessity of providing some reasonable limitation upon the extent to which this pyramiding of property taxes can go.

That is my minority report.

PRESIDENT LELAND: I am never reluctant to avoid any of the consequences that ensue from my acts. I removed Dr. Simpson, as he tells you, from the homestead exemptions committee for the reason that he gave, in saying that I promoted him to the capital gains committee. I think that committee needed his point of view, and the other committee, on the point of view of real estate, seemed to me to be adequately represented by those on the committee.

I reformed the committee in considerable part because I thought it needed reform from last year, and, in the second place, because some of the members of the committee thought so, too. You will notice, taking the list of committees throughout the session, all these six committees, that no person is a member of two committees, and I think that that is a definite step forward in committee procedure. And I still think that it was a promotion. It was to me, but had I known he would rather be on this committee, I would have gladly kept him on. That I certainly would.

MR. FARRIER: We wouldn't have had anybody to read the capital gains report then.

PRESIDENT LELAND: That is true. You can see how right my judgment was in that case.

MR. FARRIER: Of course, it might have been just as well if it hadn't been read.

PRESIDENT LELAND: That all depends on how you feel about it, I suppose.

MR. SIMPSON: I withdraw my objection, Mr. President.

PRESIDENT LELAND: This is all in good humor, brother—this is all in good humor.

Now, let us see. Is there any more discussion?

I think Mr. Sutherland is first, then the man behind the post.

Douglas Sutherland (Illinois): Mr. President and Gentlemen: I am in accord with Dr. Simpson's comment on that one paragraph in the report referring to conflict between the viewpoint of taxpayers and government.

I make criticism of that paragraph with hesitancy because of the high esteem in which all in research work and taxation work hold for Dr. Upson. He is our leader and we look to him for guidance in many things. But on that one point I cannot concur.

It seems to me that there is an inherent conflict in our society between those who pay the taxes and those who spend them. I think that it is the duty of research organizations to fairly and fully present the facts about government for the information of the communities they seek to serve, and I think it is the duty of taxpayers' organizations to make use of that material and, where necessary, to give leadership to the opposition of the citizens who are to be taxed to those taxes that may seem to be unnecessarily heavy or for unnecessary purposes.

The situation is a good deal like that which might be imagined if you can picture a conflict in interest between the employees of and the vendors to a big corporation and the stockholders. The only difference being that under our political set-up, the public official is prone to give more attention to the employee group and the group of people who are trying to get money out of the public treasury than he is to the feelings of the taxpayers, unless the taxpayers take a constant and attentive and intelligent interest in their government. That they can only take if they are given information and leadership. It seems to me the giving of such leadership and such information, not merely for the purpose of arousing conflicts, but for the purpose of helping to keep the balance, is highly essential, and that the price of economical government in this country is eternal vigilance on the part of those who support that government.

Walter A. Cooper (New York): I want to talk about the capital gains tax.

President Leland: We will give you seven minutes.

Mr. Cooper: Let me preface my remarks by saying that during the past few months I have been making a special study of the subject with particular reference to the figures that Senator Edmonds wanted.

I felt for my own practice, which involves maybe several thousand returns a year, and discussions with clients who want to know what taxes are involved in this deal or that deal, and having seen so many of them fall down because of the capital gains tax, that there was no doubt about our flow of capital into industry being

seriously influenced, and not only retarded but actually stopped in many cases.

That being a fact, what then was the offsetting advantage? Did we get any tax out of it or did we not?

I went to the treasury and got all their statistics. I have analyzed them, and I found that congress, the treasury, Mr. Parker, and now Senator Edmonds, are being really misled by these figures because they don't quite understand what they are. Perhaps I should say, not misled, but not led far enough.

Senator Edmonds told you that the loss in nine years was $80,000,000 in tax. It was far more than $80,000,000 in tax, because in his figures they have offset the tax collected on what I call trading profits, stock market operators trading day in and day out. That has produced a substantial tax and it is all in his figures. If you exclude that, your loss on capital gains is much greater.

I took the available data which went back only to 1926 and tried to break it up to find out what was the real capital gains tax excluding trading profits. You have to remember that these treasury figures are taken from that line on the return that says, "Gain on real estate, stocks and bonds," and the professional trader puts his profit on there just as much as the casual investor. So when those figures are extracted they do not represent capital gain.

Over the period from 1926, which takes in the good years as well as the bad years, our federal government capital gains tax averaged somewhere in the neighborhood of $130,000,000 per annum. But all that came in the boom years of 1927, 1928 and 1929. We had to have the wildest stock market in history to get it, and our administration is doing everything it can to prevent it; so you cannot expect to get anything like that in the future. In addition, we got the money when we didn't need it. When we need it we start losing, and we lose considerably more than his statement indicates.

I then tried to analyze it by comparing capital gains with income, and I found data available from 1917 through 1936.

As a result of that break-up, it developed that the capital gains for that twenty-year period approximated 1.2 per cent of the net income reported for tax and that wasn't complete, because it only took the gains and losses on sales. Those who prepared returns know how often capital losses were put down under the bad debt and worthless security deductions. None of those losses have been taken into account. Despite that, the capital gains was only 1.2 per cent of the income reported for tax.

Now that excludes a vast part of our national income. If you apply it to the $60,000,000 that Mr. Giblin was talking about, then the capital gain averages about two-tenths of one per cent, and I haven't said a word about the cost of collecting it which is very substantial.

To test that I had six volumes of the BTA reports analyzed, and found that of the cases involving income or capital gains questions,

40 per cent involved capital gains, and we wouldn't have had those cases if we didn't have a capital gains tax. Think of the cost of administration in the court, the treasury department and everywhere else, spending substantial sums in order to collect so small an amount of tax.

We know that that tax is harmful to business; it is keeping money out of industry. After all, when you talk about whether capital gains are a measure of capacity to pay, it is much ado about nothing because no gains are being realized on which tax will be paid, and in the process of stopping the tax we stop ability.

That is why I heartily second the idea to get rid of it.

MR. EDMONDS: May I just say one word in correction of my earlier statement? I said that Great Britain did not tax capital gains, but Mr. Cooper's debate reminds me of the fact that they do tax the capital gains of traders, those that live on the buying and selling of stocks. Their capital gains are considered as a part of their business. I would like to correct that because otherwise my previous statement would be incomplete.

GEORGE LORD (Michigan): Mr. Chairman, I want to say just a few words in defense of the so-called spenders of public moneys. Having had thirty-five years' experience in legislative and executive departments of government, my experience has taught me that if you are going to have economy in government you must first promote efficiency in government, without which you never can get economy. My experience has also taught me that the people themselves are largely responsible for the increased costs of government.

I can perhaps better illustrate my point by telling you of an incident that happened during my legislative experience.

The president of one of our larger state institutions came to Lansing, the state capital, with his budget, about 100 per cent more than he had for the current biennium, insisting that he must have this increase in order to conduct the institution as it should be conducted.

The governor was very much alarmed and he called a few of us into his office to talk over this proposed budget. After questioning the president, I said to him as chairman of the steering committee of the legislature, that he could not possibly get anywhere near what he was asking. He became quite angry, thumped the desk and said that he would quit the presidency of the institution unless he could get what he wanted.

When the people in Detroit and other places in the state found that I was opposed to this budget, I received more telegrams and letters from civic organizations, business organizations and citizens throughout the state than I received during all my previous legislative experience, urging me to support the budget and even going so far as threatening me that I would get defeated if I ran for the legislature again.

We reduced that budget about 40 per cent, and when the appropriation act became the law, the president of the institution turned and said to me, "I am perfectly satisfied; I think we will be able to get along all right." After the legislature adjourned, mind you, these same people who wired me and wrote me to support that budget damned the legislature for being extravagant.

Now, these are some of the things that public officials have to face. I don't think that anyone here has done more by way of writing and public addresses condemning the extravagance in government than I have. There again I think the people are largely to blame because they take so little interest in what is going on, and they will wait until the money is spent before they condemn, instead of coming to the budget hearings and placing their grievances before the budget commission.

Here is another thing, and now I want to speak just a minute, Mr. President, in defense of the federal government's spending.

The federal government is spending too much money. All governments are spending too much money. But this is what I have found in Washington.

We have in the United States, as you know, an organization of mayors; we have an organization of governors; we have other organizations, whose primary purpose is to get more money from the federal treasury to take back home, and then they say to their constituents, "We have been to Washington; we have gotten so many hundreds of millions of dollars for this project and that project, and it won't cost you people anything."

These are things that public officials have to face. I have sat in with the ways and means committee, with the finance committees, and I have seen those members of the committee sweat great drops of blood to keep appropriations within reasonable bounds; and then some representative of an organization will appear to demand that so many hundreds of millions of dollars be appropriated for this cause and that cause in their home districts.

Let me tell you something, gentlemen: you are never going to get politics out of government. When someone comes from Detroit, from Cleveland, or from any other city or state in the Union, to their congressman and says to him, "I want you to vote for such and such an appropriation," nine times out of ten he will vote for it, because he is holding a political position.

I repeat, gentlemen, that if you want economy in government, you must stop this kind of thing and promote efficiency in government, and then you will have economy in government.

M. D. Bachrach (Pennsylvania): I would like to add just one observation, possibly in a lighter vein, that might also help to promote economy in government. That is, if it were possible to adopt some other word in the English language to denote a billion dollars, because, unfortunately, the word "billion" sounds almost the same

and is just as easy to pronounce as the word "million." I became curious one day to find out the difference between a million dollars and a billion dollars, and I was very much surprised to find out what a startling difference it was. I believe many of you will be equally surprised when I tell you how much the difference is.

If you should go to a bank and ask to withdraw a million dollars and say that you want it in thousand-dollar bills, in brand new thousand-dollar bills, you will get a package which will be eight inches high. Now, if you take that package of a million dollars all in thousand-dollar bills and place it on the sidewalk in front of the bank and then place alongside of it another package containing a billion dollars in brand new thousand-dollar bills, where the million dollar package reaches eight inches above the sidewalk, the billion-dollar package will reach to the top of a sixty-four story building.

President Leland: Vas you dere, Sharley?

Mr. Bachrach: That can be mathematically proved, and I believe that if the legislatures of our government were aware of that tremendous difference, they might not be so ready to toss about the billions.

President Leland: Well, that is an interesting experiment. I hope the members here will remember that in their homes.

Is there any further discussion?

You might get that money and put it end to end and see how far it would reach. That is another interesting thing you can do with it after you get it.

Mr. Doyle: Could I say just one word for educational purposes?

President Leland: Yes, nobody else wants to say anything.

Mr. Doyle: I think one fault of a lot of our people, and especially the gentlemen who come from colleges, is that they have too high an opinion of the people. They themselves are living in magnificent and luxurious surroundings, on beautiful campuses, with literature and art all around them, splendid young men and beautiful young women. They think people are pretty fine, you know. But if they could go, as I have, and see five hundred thousand Italians yell, "Viva Mussolini," and then get a plate of bean soup to eat, which is all they do have to eat these days; and then hear the same number yell, "Heil Hitler," and get a plate of cabbage soup, and see how they live, how poor they are, and what darn fools they are, they would have the same respect that I have for the people.

Mr. Edmonds: If Mr. Doyle is giving educative reminiscences, I would like to give three.

The first is to Mr. Lord. A very wise old gentleman whom I knew in Philadelphia once said to me at the end of his life, "This is the lesson of my long life:

> 'Strive if you will to save a sinking land;
> All fear, none aid you, and but few understand.'"

That is Alexander Pope. The man who told me that, by the way, was George H. Earle, the first, the grandfather of our present governor.

The second reminiscence: Last summer over in England, when I had the pleasure of a conference with one of the members of the English Board of Inland Revenue, which collects all of their income tax on revenues, he said: "In America you pay too much attention to theorists. What do theorists do, anyhow? They just get you jittery."

The third is a quotation from Will Rogers which I think will give more comfort than anything else, namely: Will Rogers said once that there are only two fixed facts in American political life. The first is that the American people will get tired of the Republican Party after a certain length of time. The second is that they get tired of the Democratic Party in a shorter time. (Laughter)

MR. SIMPSON: Just in answer to the attack on college professors: I saw an alphabetical jingle somewhere sometime ago. One couplet in it caught my attention. When the poet, if he was a poet, got down to the letter "H", he seemed to be in difficulty. He said — and this, I think, is verbatim: "'H' is for horse sense; how few possess it; found only in horses and college professors." (Laughter)

PRESIDENT LELAND: Thanks, Brother Simpson.

C. C. BROWN: May I say just one word on this educational business, something I know absolutely nothing about?

PRESIDENT LELAND: You are not the only one.

MR. BROWN: Except the cost of it. In Oklahoma ten years ago the legislature appropriated $150,000 for a few weeks' school. I believe it was ten; it might have been twelve. For the last biennium, 1937 — rather, for the present biennium — they appropriated $12,800,000 annually for the support of the common schools.

It is true that in the meantime we had reduced our ad valorem taxes considerably. That is quite a substantial increase. I know that it is not all needed, for the reason that I lived in one of those school districts.

Then, there is another thing about education. I believe in it. I used to go up to MIT and hire a lot of engineers to put in the oil business. I was criticized by the oil men for it, but I still believed in them. Most of them made good.

Still, with all of that, I have never understood why Oklahoma had to educate all of the geologists and all of the petroleum engineers to develop all of the oil in all of the world. (Laughter)

CHARLES V. GALLOWAY (Oregon): Mr. President: I came here all the way from Oregon with the firm determination to sit and

listen, to say not a word. Senator Edmonds' reminiscences have caused me to break the rule.

With my good friend, George Lord, I attended my first conference of the National Tax Association in 1909 in Louisville. There is one thing that brings a reminiscence out of that conference: a little discussion arose as to whether it would be feasible and practicable to inject into such conferences considerations with respect to federal taxation. Most of the members there assembled at that conference held the view that the deliberations of subsequent conferences could be confined appropriately and properly to state and local taxation, for questions and problems of federal taxation were so incidental and immaterial as to be of little consequence. (Laughter)

Acting on a hunch of some sort, I made my first remarks on that subject, and expressed rather apologetically and simply the view that I thought the time might possibly come when federal taxation, or taxation of various agencies of the federal government, might become a matter of some consequence in our deliberations. Now, after twenty-nine years, I hope to live to attend a conference where matters of federal taxation will be covered, regarded as of some importance. I should not be surprised if that would develop. (Laughter)

I also remember that at that conference there was a professor emeritus of a little freshwater college in one of the central states who came down but he was not on the regular program. He brought a paper, so-called, probably it would have covered half an acre if spread out and would have required in the reading two hours in passing a given point. He sought at each opportunity in the discussion to present his paper, but chairmen in those days, as now, were exacting and watchful, and he was stopped time after time.

He got me in a corner and gave me some of the substance of his paper. It was entitled, "What shall we do to escape unjust taxation?"

Turning to these times, I think now more appropriately the paper should be entitled, "What shall we do to tolerate and endure unjust taxation?"

You know, after nearly thirty years, I am minded to tell a story that is a homely illustration or has a homely basis. I come from a stock-raising country and I have been something of a stock-raiser myself, incidentally. I have been nearly thirty years in tax administration work and what money I have made there I have spent in agricultural pursuits. (Laughter)

Anybody who has handled livestock has to do some counting sometimes and I developed a simple formula, comparable perhaps to the simple processes of thirty years ago, that when we counted livestock, sheep or cattle, we grouped them in bunches. I thought I was rather an adept in counting a thousand head of sheep or cattle

by bunching them in five's or ten's, if they were spread out broadly enough.

But I learned a new process recently. I will tell you how a professional cow counter works. There was one on the train coming through a dairying country. Some passengers observed that he was practicing. He had his nose against the window and he seemed to be intensely engrossed in something that was going on outside. Some of the timid women passengers thought he might be a crazy man, so they called the conductor. He went over and touched the man on the shoulder and said, "My friend, what are you doing? You seem to be interested in something,"

He said, "I am a cow counter. I have a system all my own. There are a lot of cows along here. This is a dairying country, and I was counting the cows for practice."

"Well," the conductor said, "that is interesting. Let me see you do your stuff. We are coming to the largest dairy range in the world. It extends for about four miles along here." The train was going a mile a minute. "I would like to see you count the cows in these pastures and meadows."

"All right," he said, "I will do it."

So, as the train came to the pasture he went to work with a lot of facial contortions and a good deal of emotion for about four minutes. The conductor said, "That is all. How many are there in that pasture?"

He said, "There are 4,672 cows in the pasture."

The conductor said, "That is remarkable. I saw the manager of that plot just a day or two ago and that is exactly the number he told me were there. How in the world did you do it?"

"It is simple enough," he said. "Each cow has four teats. I just counted the teats of the cows in the pasture and divided by four, and I had the exact number." (Laughter)

It seems to me, from listening to these discussions, that we have progressed wonderfully in our tax processes, and had that man been trained as a tax accountant under modern methods, he would have been entitled to a certification as a tax expert.

My time is up, I guess, so I will not venture any further observations. Thank you.

President Leland: Is there any further discussion or are there any other stories you would like to present?

Mr. Edmonds: I move we adjourn, Mr. Chairman.

(The motion was duly seconded.)

President Leland: The meeting is adjourned.

(The meeting thereupon adjourned at five-five o'clock.)

SIXTEENTH SESSION

FRIDAY, OCTOBER 28, 1938, 8:00 P. M.

PRESIDENT LELAND, presiding.

PRESIDENT LELAND: I want to introduce this evening, Mr. William H. Stauffer, former economist of the tax commission of Virginia, now director of public welfare of that state. Mr. Stauffer, unfortunately, is with us only *in absentia*, and has asked me as a personal favor to read his paper, which I will try to do as well as I can. The title of his paper is, "The Cost of Relief in the United States."

RELIEF COSTS IN THE UNITED STATES

WILLIAM H. STAUFFER
Commissioner of Public Welfare—Virginia

In these days, any discussion on the costs of relief is apt to result in polite mud-slinging if not in physical violence unless both the audience and the speaker happen to be of the same political faith and of the same denomination within that faith. For that reason, your speaker very hesitatingly agreed to present to this group a discussion of the costs of relief.

I made note, however, that those who prepared the program left this discussion until the very last thing on a five-day program. This might have been done for either of two reasons, and from these you may take your choice. Your committee probably thought that if it were left until last most of those in attendance at this conference would have gone home by the time it arrived and thus have been spared a menace to body and mind. Or, in less belligerent mood, your committee might logically have concluded that with all of the taxes to which the average citizen is now exposed, the sequence of events, unhappily or otherwise, turned out that when he got through paying taxes he was ready for relief himself.

This last statement brings me to the point about which I believe a discussion of the costs of relief might properly revolve. I do not propose to answer all of the questions which can be asked, but we ought to be thinking about some possible answers. The important question, as I view the situation, is this: "At what point do the costs of relief presage more harm than good to the economic and social welfare of the nation?" To state the matter another way; it is desirable and profitable to a community to undertake the relief

of destitution at public expense up to a certain point. Beyond this point, the community might actually suffer both economically and socially by reason of the fact that more harm is done than good.

We have read and heard considerably regarding the unwise, wasteful, undemocratic and uneconomic spendings which have been made for relief of unemployment and destitution throughout the country. These damaging epithets have not all been hurled by enemies of the present administration. A few serious folk have, in all sincerity, raised their voices in question. We have moved along year after year since 1929 hoping that recovery was to be found in the street into which we were just about to turn, and because of that hopefulness we have dealt generously with public funds in providing works relief, direct relief, and various other types of relief. In other words, we have been guilty of the somewhat questionable economics of endeavoring to spend our way out of adversity.

I should not like to be considered, in view of the remarks which I have just made, as being condemnatory of any particular group or groups of either political reformers or debunkers. Neither am I particularly complimentary. As a matter of fact, I believe we have all demonstrated a degree of helplessness which was born partly out of ignorance and partly out of fear.

In fairness to all aspects of the question of relief programs and costs, there is one important observation which should be presented and which is not infrequently overlooked. Relief expenditures serve a dual purpose. This purpose is both individual or personal and social. Such expenditures give to the individual a means of maintaining life and thus stand as a barrier against utter deprivation and destitution. They operate at the same time to maintain the purchasing power of the community and thus stand as a deterrent to the further slowing down of the economic machine. Sustained purchasing power means stability for industry. Stability for industry means the welfare of us all. Obviously, however, there are limits to the ability of the industrial machine to continue functioning if the community attempts to draw too heavily upon industrial production for the support of unproductive relief recipients. Avoidance of this hazard demands thoughtful planning.

We need to make a further distinction, I believe, in the use of the term relief. Some types of relief aim toward social and economic productivity. These types we have come to designate as work relief. Under programs of this type the government seeks to aid unemployed persons by making jobs. These jobs are made by means of projects of various sorts. Every community throughout the country has had its experience with work relief projects. They range from dams and bridges to sewing rooms and bird sanctuaries, from national histories to local indexing, from national planning to local traffic counts.

Some of these projects are good and of high economic and social value; others are worse than useless in these connections. For the most part, they are essentially sound and are deserving of considerably more study and civic interest than the American public has thus far displayed.

My first constructive point is that we ought to recognize the need for a more or less constant national public works program. The most serious charges that can be made against work relief is that it has been well-nigh a planless undertaking. True, we have done what seemed at the moment most expedient in the light of the emergencies, but we still operate our public works relief on a hand-to-mouth basis. This is not as it should be. It is uneconomic and wholly unworthy of the traditions of American business sagacity.

Nor is responsibility for this situation to be laid any more to the present administration of governmental affairs than to its critics. For, although I have heard many loud and lengthy denunciations of the handling of relief, the voice of constructive and practical suggestion has not often registered, or if it has, my ears have not been attuned to it.

The philosophy of work relief is, as I have said, sound and altogether defensible. But work relief, as I would define it, means something more than just spending taxpayers' dollars on anything that can be concocted as an employment opportunity. It means a careful planning of those types of projects which result in the creation of definitely advantageous goods or services.

A great deal of just criticism has been made of the fact that our work relief has made thriftless and lazy men even more shiftless and thriftless than before. This has resulted rather from careless selection of the persons employed, and from inefficient direction and supervision of the labors than from any unsoundness in the principle. Since most humans are inherently lazy perhaps I should use the word lethargic before this group—it doesn't require a great deal of inducement to bring that quality to the surface. Good projects go bad because of incompetent direction and management. I do not need to elaborate by citing specific examples, but I do want to say that these difficulties are not insurmountable.

Another disturbing feature of our work relief activities, it seems to me, arises from the fact that we have attempted a much larger coverage of employment opportunity than is reasonable. We have carried into the lists of certified relief workers great numbers of our population who, on any reasonable definition of emergency need, certainly should not be there. Even in the piping times of prosperity, one can find throughout the length and breadth of the land hosts of individuals whose economic status borders on the level of destitution. Another large group is to be considered as falling in the near marginal group. These two types are equally prevalent in both rural and urban communities. I hesitate to advance the

thought that a goodly number of them do not want a better status, for that would seem to fly in the face of the theory of the instability of men's wants, but I shall be bold enough to state that no inconsiderable number of such persons assuredly do not merit the opportunities afforded by a social work relief program. And I am, therefore, distressed on viewing my responsibilities as a taxpayer when I realize that we are attempting to absorb as legitimate relief clients so large a portion of the population who ought not to be there. In this field I am convinced the thoughtful American public would welcome a purge. This welcome would by no means be restricted to the boxes of the alleged plutocrats, but would resound from the orchestra of the great middle class, which in this country is today carrying the major load of governmental expenditures.

I have dwelt at some length in commenting on public work relief as a means of social and economic safeguard. I have said that it deserves more thoughtful consideration and careful planning than it has received. I have made certain observations of its weakness in the methods of direction and supervision, and I have bespoken my distress over the fact that many are given employment at public expense who ought not to be there. I believe that most of the ills can be remedied, if there is the will to remedy them.

By far the larger part of the costs of work relief has been borne by the federal government. Beginning in 1933 with the Federal Emergency Relief Administration, the Civil Works Administration, and the Civilian Conservation Corps activities, we have successively experienced their analogies in the special works programs of the Federal Emergency Relief Administration and the Works Progress Administration. For the six-year period ending June 30, 1938, federal expenditures on account of the activities just referred to amounted to somewhere in the neighborhood of $10,000,000,000. The major part of these costs has been devoted to work relief. In the early relief programs the federal government made available to the states fairly large grants for the purpose of direct relief, but it very wisely removed itself from this field under the later programs. With the exception of the distribution of surplus commodities (principally agricultural products purchased by the government in an endeavor to stabilize farm prices) the federal relief activities are today almost entirely on a work relief basis.

As I have said, the federal government is bearing the main burden of relief costs and these costs arise by virtue of state and locally sponsored work projects of various types.

Let us turn now to that form of relief commonly known as direct relief or general relief. This type of relief takes various forms, such as the delivery of commodities directly to the client, purchase orders for groceries or other living needs of the client, and outright cash payments. General relief comes close to being a dole system. It is generally predicated upon the need of the client, measured at

a bare subsistence level. Under a more perfect system than that characterizing our present-day relief devices, this form of relief would be restricted to unemployable persons at a near destitute level. Its application to employable groups is both uneconomic and subversive of social morals. Any extended use of this system to able-bodied persons tends to break down self-reliance and initiative and to breed paternalistic and other anti-social behaviors.

Some application of general relief is inescapable. Even in prosperous times we have the problem of the family without an able-bodied wage-earner. Prior to the passage of the Social Security Act, the need for general relief was immeasurably greater. The passage of that act and the resultant actions of the state legislatures in setting up plans for special aids to the needy aged, the needy blind, and the dependent children should operate to diminish the number of persons falling within the general relief system.

Be that as it may, the state and local governments are carrying heavy general relief budgets and are likely to continue to do so in spite of recovery, unless steps are taken to remedy the evils which have crept into the system. From January 1935 through July 1938 approximately 2½ billion dollars had been spent for general relief by the state and local governments. More than one-half of this total was spent in the calendar year 1935. In 1936 the expenditures fell off by more than two-thirds and this decline continued until the latter part of 1937. The reasons for this decline were three-fold. First, the WPA work relief programs got under way during the last months of 1935 and the monthly volume of these expenditures was fairly constant until about the middle of 1937. As the work program developed, it took off the general relief rolls thousands of able-bodied workers and absorbed these on work relief. Second, the general economic curve was on the upward trend until the middle of last year, and private industry absorbed a substantial number of previous general relief clients. Third, the application of the categorical assistances to the aged, blind and children were becoming operative throughout the states and were absorbing into the categories thousands who had previously been carried on general relief.

We may illustrate these shifts by comparing July 1935 with July 1938. In the earlier year, the July expenditures for work relief including the Civilian Conservation Corps amounted to approximately $35,000,000 while the general relief totaled $119,000,000, and the categorical (or social security) assistances totaled $10,000,000. By July 1938 work relief expenditures had risen to $179,000,000 and the categorical assistances to $43,000,000, while general relief expenditures dropped to $37,000,000. Compared percentage-wise, work relief costs were increased by 410 per cent and categorical relief by 330 per cent, while costs of general relief were curtailed by approximately 70 per cent.

As I view it, these movements have been in the right direction, though I cannot undertake an appraisal of the magnitude of their respective levels as they appear in the budgets of federal, state and local governments at this moment. After all, that is not the purpose of the present discussion, assuming that any speaker could address you with the voice of authority on what is the defensible optimum. These trends are rightly directed for the following reasons:

1. If we must have relief for the employable unemployed, it is better to have the beneficiaries of such relief *work* for their money. We should, of course, see to it that the evils existent in the present program are reduced to the irreducible minimum and some of these menaces I have already noted.

2. The development of special assistances based upon actual need for the aged, the blind, and the underprivileged children, promises a more satisfactory handling of a social necessity than the pre-existing forms of poor relief. And though it may seem trite for me to say so, I would have it clearly understood that I am utterly unsympathetic and unresponsive to the scatterbrained advocates of such idiotic philosophies as "thirty dollars every Thursday" and their ilk. The best that can be said for them is, that they will be forgotten quickly enough. And if it should happen that the advocates of such plans are elected to high office, or that fundamental state laws are changed to experiment on the impossible, I can with all assurance predict that the elected will retire in ignominy and sanity will ultimately prevail.

3. Work relief is more properly financed by the national government than by local government. The factors giving rise to general economic slow-ups cannot today be regarded as local; therefore the remedies established to prevent or correct such conditions constitute national problems. There is little to be gained by the now academic argument of the threatened impairment of states rights when the national authority can more adequately cope with situations in which the states for the most part have demonstrated relative incompetency.

4. General relief is not a recovery device; it is the least defensible type of relief for any but relatively short-time emergency needs. While it is true that this form of relief is the oldest, it is also the least constructive, the least productive, and consequently the most costly in the end. I would not minimize the fact that it has alleviated human suffering and has played an important rôle in the welfare financing of the past nine years. But the past nine years has been a school where much learning could be had, and I believe the American people are learning.

And now I should like to discuss in a general way the matter of administrative costs in connection with relief programs. A great deal of free advice has been offered by those who oppose relief appropriations on the ground that administrative costs are too high.

The usual comparison is to examine a situation in which the relief program is very low as to benefits and to find that the administration overhead looms up in relatively high proportion to these benefits. Such comparisons have been made within my own state and I need not go beyond for adequate illustration of the fallacy of most of these criticisms.

In Virginia general relief and the categorical assistances, excepting to the blind, are administered through the State Department of Public Welfare. In some of the counties of the state the need for general relief is relatively small. We administer our relief through the local welfare agencies of which there is one in each of the state's 100 counties and 24 independent cities. These local welfare units perform an over-all service in welfare, functioning as the certifying agencies for the W. P. A., the C. C. C. and the N. Y. A. They handle the distribution of surplus commodities, and serve in carrying out the requirements of the law respecting child welfare and juvenile and domestic relations matters. To all of these are added the routines incident to the administration of general relief and the categorical assistances.

The staff of each local administrative unit averages about four persons, consisting of a superintendent, an office assistant, and two case workers. The average cost of operating such a unit amounts to about $5200 annually. In this cost are included the salaries of the personnel, traveling expenses, supplies, equipment, materials, light, heat, insurance, telephone service, and rental of space.

It can readily be seen that if the dollar relief needs are limited in one of these areas, the ratio of administrative costs to assistance grants will tend to be relatively high. And yet the granting of assistances involving investigations, preparation of records, and follow-up case work may represent only one-half the normal load of duties devolving upon the unit. The average critic, however, fails to appreciate these non-monetary aspects of the local welfare agency and makes his determinations on the outright comparison of administration costs against money grants to beneficiaries.

A further evidence of the unfairness of such comparisons occurs when one considers that a well-staffed welfare unit may actually be more economical to the taxpayer than a limited and untrained staff. Proper investigations and good case work, with emphasis on educating prospective relief clients in the ways of self-sufficiency can result in a diminution of the moneys required to be expended for relief. Theoretically, at least, the ideal welfare unit would be one in which no relief expenditures were necessary, in which case the administrative costs would represent 100 per cent of the total costs. This ideal will of course never prevail but it illustrates the point I wish to make, namely, that good administration requires reasonable costs, and that the ratio of such costs to the amount of money pay-

ments to relief clients is meaningless without supplementary data indicating the relative efficiency of the particular operating unit.

As a matter of fact, in Virginia, which has entered the field of relief on a more modest scale than most states, a comparison of administrative costs and total costs of the program which probably show a relatively high ratio when compared to other states, yet it may well be that under proper testing, the relative efficiency and effectiveness of Virginia's system would indicate a high degree of economy.

I have but one other major observation to make. This has to do with the matter of controlling relief expenditures within the state. I do not know much about the devices employed in other states but from my reading of the news I suspect that in some of them the principal devices have been politically inspired, and with disastrous results. Again you will bear with another illustration from my own state.

Under the Virginia Public Assistance Act of 1938 all of the political subdivisions of the state are required to prepare annual welfare budgets. These budgets carry the proposed expenditures for general relief, for aid to the aged needy, aid to the needy blind, aid to dependent children, and for administrative costs. These budgets are prepared by the local boards of public welfare. They are then submitted to the state commissioner of public welfare for his approval. The commissioner reviews the budgets in the light of certain maximum allocations which have previously been sent to the local welfare boards. These maximum allocations represent the ceiling of state and federal funds to which the localities will be entitled and are based upon estimated case loads and presumed individual living needs. If the local welfare budget is within these maximum allocations (which include such part of the moneys as are required to be raised locally) the commissioner approves it and returns it to the governing body of the locality for their approval and appropriation.

When so approved, quarterly budgets are prepared by the local welfare board and these must be within the annual budget. By this means protection is afforded not only to the state appropriation but to the local treasuries as well. The local welfare boards know that they must live within the approved budget. The quarterly budget enables them to effectively do this.

For all of the categories and for general relief the state contributes one dollar for each 60 cents raised locally. The federal supplements make it work out that the state pays 31¼ per cent of costs for old-age assistance and aid to the blind, while the localities bear 18¾ per cent of such costs. For the dependent children the state contribution is 41⅔ per cent and the localities 25 per cent. The federal government contributes 50 per cent of the costs for the

aged and blind, and 33⅓ per cent of the costs for aid to dependent children. In the matter of general relief the state contribution is 62½% and the local contribution 37½ per cent.

Virginia is the last state to come into the picture so far as the categorical assistances are concerned. I believe it has justified its conservative delay. It will continue to be conservative in the sense of proceeding to advance only when it is reasonably sure of the direction in which it is headed. Unfortunately, the same cannot be said of all states.

PRESIDENT LELAND: I have finished reading the paper for Professor William H. Stauffer, of Virginia. I wondered how in the world he got into the welfare field, but the last paragraph there with the budget law indicates clearly how the economist may have wandered over there.

Mr. Carl P. Herbert, who was to discuss this paper, was unfortunately called home, so that our next order of business this evening is to receive the report of the social security committee, of which Mr. Roy Blough is chairman.

Mr. Blough is going to take charge of our discussion at this point, as he wants to introduce two brief discussions as a preface and a general background of understanding for his report. I will gladly turn this part of the discussion over to Mr. Blough.

J. ROY BLOUGH, presiding for the period of the discussion on social security.

CHAIRMAN BLOUGH: Instead of simply having a report of the committee, we are first going to have two papers that were submitted to the committee by members of the committee—rather highly technical papers, by authorities in their fields. I am sure you will find them extremely interesting.

The first of these papers is on the problem of administration. "Definitions, Forms and Procedures," I believe is the title. Mr. Harry Gretz, of the American Telephone and Telegraph Company, who has been a member of the committee during the past year, has prepared the paper and will read it at this time.

H. C. GRETZ (New York): Mr. Leland, Mr. Blough, and Members of the Conference. I don't think I was very smart. I stayed around here. I find that most of the other fellows who had some work to do have gone home.

PROBLEMS IN THE ADMINISTRATION OF SOCIAL SECURITY AND SOME SUGGESTIONS FOR OVERCOMING THEM

HARRY C. GRETZ, NEW YORK

You gentlemen of the National Tax Association are primarily interested in tax matters and I am not a tax specialist but an accountant. Therefore, you are entitled to an explanation of how I came to be placed on your committee on social security legislation, why I am addressing you, and what are my qualifications for a paper on social security.

After your annual meeting last year, your president asked your treasurer, who happens to be in charge of tax matters for my company, to suggest some one to serve on the social security committee. By that time most of the work associated with the social security program fell on accountants, and since that was one of my assignments, my name was proposed by your treasurer and in due course I was advised of my appointment.

At the initial meeting of the committee last spring I was assigned to prepare a preliminary draft of a section of the committee's report on "Definitions, Forms and Procedures." For the reasons Chairman Blough gave you, the committee as a whole never acted on this draft and I was asked yesterday to present it as a paper. I reluctantly accepted, and that is the reason I am on the program this evening.

The other explanation I desire to make has to do with my qualifications to speak on this subject. I want to make it plain that I have no claims to pose as an expert on the broad aspects of social security. I became interested as an accountant, after the laws were on the books, and my particular interest is entirely confined to the administrative side. I am anxious to see that the laws as they do appear are efficiently and economically administered, and if it becomes apparent that the particular type of law does not lend itself to efficient and economical administration, then I am interested in what might be termed technical amendments that will produce the desired results.

So much for the introduction.

The section of the committee report to which I was assigned was intended to deal with the simplification and standardization of (1) forms of collecting taxes and information; (2) definitions of terms used in such forms and regulations; and (3) collection procedures, including the question of the frequency of the tax collections and information reports.

Nothing could be gained from a detailed analysis of each of the forms used for collecting taxes and information as required by the

laws and regulations under the Federal Security Act and the 51 state unemployment compensation acts. It seems more important to analyze the overall administrative procedures in the light of experience to date and first determine whether there is need for simplification in administrative procedures and, if so, whether it can be accomplished through a simplification and standardization of forms, definitions and collection procedures, or whether changes in regulations are in order, and finally whether changes of a more or less fundamental nature are required in the laws themselves.

In order to obtain a systematic approach, it appears desirable to discuss first the problems in administrative procedures growing out of the old-age insurance provisions of the Federal Social Security Act and then take up the problems incident to unemployment insurance.

Old-Age Insurance

There are two main functions coming under this heading, viz., the collection of the tax and the payment of benefits. Since old-age insurance is limited to the Federal Social Security Act, the functions of collecting the tax and the paying of benefits are the responsibility of the federal government.

Taxes are assessed on the first \$3,000 of wages paid in any year to an employee by an employer of one or more employees, in covered employment. The present rates are 1% from the employee which the employer is required to deduct from wages paid to the employee and 1% from the employer. Prior to the year 1938 the employer was required to pay both taxes over to the federal government monthly. Beginning with January 1, 1938 taxes are payable quarterly.

The payment of benefits at the time the individual worker reaches age 65 or dies, requires the establishment by the federal government of a wage history for each employee in covered employment beginning with January 1, 1937. As a preliminary to setting up these wage records, it was necessary to work out a plan to identify each wage earner. This plan contemplated the registration by the worker (Form SS-5) and the assignment of a so-called "Account Number" to each registrant. Recent announcements by the social security board indicate that account numbers have been assigned to more than 40,000,000 individuals. Wage records for these individuals are set up in the old-age insurance division of the social security board in Baltimore.

Regulations issued by the treasury department require employers to periodically file information returns showing for each employee, his name and account number, taxable wage paid, date of separation and state in which employed. The only items on which we might comment are the last two, and such comment would be to the effect that neither item has any direct bearing on the payment of benefits.

On the other hand, the furnishing of these data is not particularly burdensome to employers.

During the year 1937 information returns were required for the first six months and for the second six months (on Forms SS-2 and SS-2a). Beginning with 1938 a combined tax and information return (Forms SS-1a and SS-1b) was put into operation with the information as to employees being listed on forms with a summary serving as the tax return. This summary provides for showing (a) the number of taxable employees, (b) total taxable wages paid, (c) employer's tax and (d) employees' tax. Lines are also provided for prior period adjustments and corrections. This report is probably as simple in form as can be desired and the only pertinent comment goes to the frequency of reporting.

As to the frequency of tax reporting and payment, it is felt that quarterly payments due within one month after the end of the quarter is perhaps proper considering all types of employers who are required to report and pay the tax. However, there is some merit to the contention that since the employer acts as the agent of the government in collecting the tax from the employee and is responsible to the government for it until it is paid into the government, the tax should be collected monthly. While it is felt that this contention has some merit, it is not believed to be of sufficient weight to consider placing the tax collections on a monthly basis. It is felt that it is of sufficient importance to offset any demand for reporting less frequently than quarterly.

Information returns of employee wage payments present a different picture. There appears no justification for requiring information returns more frequently than once a year and well-established businesses, whether large or small, might be depended upon to maintain these records for so long a period. It is true that the government must have at age 65 or at time of death either before or after attaining age 65, an earnings record of each covered employee after January 1, 1937 (which is not true with one exception under the state unemployment compensation laws). It was felt that small employers would fail to keep records and therefore would not be in a position to file at annual intervals. Experience under the lump-sum payments for old-age insurance and under the actual payment of unemployment compensation benefits has dissipated this doubt. Because of the length of time necessary to establish the old-age insurance wage-earning records, the board had to depend on employers to furnish complete wage data back to January 1, 1937. The board is on record that employers did a splendid job in this reporting. In connection with the payment of unemployment benefits growing out of disputed cases where the records of the state agencies were not up to date or were in doubt, employers were required to file retroactive wage-earnings data even though similar data had been currently filed previously. Prompt and complete reporting

under such conditions has been acknowledged by several state commissions which report that the only cases where trouble was experienced was with employers who had not paid taxes nor filed returns.

The treasury department places great weight on the "self-balancing" feature of the combined tax and information return. It must be admitted that for the first six months' period of 1937, employers filed information returns which failed to check in the aggregate with the tax returns previously filed monthly, thus causing the collectors' offices considerable trouble and delaying the submission of the returns to the old-age record office. There was some excuse for this because the administration of the law presented new problems, and forces had not been properly trained to handle the enormous amount of detail. Then, too, rulings were being issued and many of them required retroactive adjustments back to the beginning. Much improvement was had all along the line in the second six months' returns. The old-age insurance record office has reported that while only 4.5 million reports of wages paid to individuals were received in two months after the close of the first reporting, 35 million reports were received in the two months after the close of the second reporting.

This question resolves itself into whether employers, the bureau of internal revenue and the old-age insurance division, are justified in the expense of handling four times the volume of work to secure whatever advantage there is in the so-called self-balancing combination tax and information return. If the government is not willing to make this provision applicable to all employers but is willing to give it a trial, it is suggested that it be made optional for well-established employers, both large and small, who can meet reasonable specifications attesting to their stability, and who will agree to maintain individual wage-earning records, reasonably safe as to fire and flood.

Unemployment Compensation—Federal Title IX

To quote from Title IX of the Federal Social Security Act, "This title levies upon employers an excise tax payable annually, measured by wages, and allows each taxpayer to credit against his tax the amount of contributions he has paid under state unemployment compensation laws." The present tax rate is 3% payable by the employer on his total payroll for covered employment. Most of the state laws provide for a tax of 2.7% on the total payroll for covered employment resulting in the federal government retaining 0.3% of the total payroll.

While the above-mentioned tax is not specifically assessed to cover the cost of state administration, the federal act does provide under title III "for payment to each state which has an unemployment compensation law approved by the board under title IX, such

amounts as the board determines to be necessary for the proper administration of such law during the fiscal year in which such payment is to be made."

To date the federal government has collected more under title IX than it has paid out under title III but it is impossible at this time to determine conclusively what the normal relationship will be. The federal tax is due not later than January 31 for the tax applicable to wages of the preceding year, which means that the tax at the 3% rate first applicable in 1938 will not be due until January 31, 1939. On the other hand, only one state paid benefits prior to 1938; 22 began in January, 1938; 8 more will begin during the remaining months of 1938; 18 in January, 1939, and 2 in July, 1939. While data might be had as to the current administration expense for those states paying benefits, no data are available of the government's receipts by states. There apparently is some concern as to whether the federal government's share will be adequate to cover the total administrative expense when all states are paying benefits.

The forms used by the federal government for tax reporting under title IX are relatively simple. The provision in section 902 of the federal act that credit may be taken for contributions paid to the states before the date of filing the return for the taxable year (January 31, following) places an undue hardship on the taxpayer where retroactive adjustments are in order, e. g., where a post audit discloses employment in a state different from that actually reported. This was taken care of as far as payments applicable to wages for employment in 1936 are concerned, in the 1938 revenue act (section 810). It is suggested that similar action be taken to make this applicable to reports after 1936.

Tax Base Under Title IX

While not tied into the administrative procedures, some mention should be made of the tax base. Unemployment compensation was not designed for the high-salaried worker in relation to his salary. The same is true of old-age insurance but, in this instance, and in order to maintain some consistency between the tax base and the benefit base, only the first $3,000 of annual wage is considered for old-age insurance taxes as well as benefits.

This is not true for unemployment compensation for, while the benefits are limited usually to $15 a week for a limited period in a benefit year, the tax is applied to the total wages. This may have been due to the fact that the tax base is fixed by the federal law which contains no provisions as to benefits, the latter being included in the state laws. Because of the provisions of the federal law as to credits for contributions paid to the states, it is necessary for each state, in order to secure its 90% of the gross tax, to use the same tax base as the federal government. To reduce the tax base

below the federal base will result in placing a larger share than the 10% intended into the federal treasury, at the same time reducing the amounts placed to the credit of the state unemployment compensation funds.

Only two states (New York and Michigan) have limited wages, $3,000 per annum being the maximum in each of these two states. Two other states (Vermont and New Hampshire) in their laws have provided for limiting taxable wages to $3,000 per annum per employee, if title IX is changed. Some of the states which collect employee contributions limit the tax base for this purpose without limiting it for employers' contributions. The Towey Bill H. R. 9209, introduced at the last session of congress, is intended to correct this situation. If this bill is passed by congress, legislation to conform the state laws to the amended federal law so amended, should follow such federal amendment.

Now, as to definitions under the federal act and regulations. There are inconsistencies in the law with respect to covered employment, covered employees, and in the use of wages earned and wages actually paid. These inconsistencies do not seem to have any real justification and, on the other hand, are extremely annoying to taxpayers. Some relief was given in the regulations under which wages paid might be reported when actually paid or constructively paid. The social security board fully realizes this condition and it is understood that it has already submitted to congress its recommendations which will bring these definitions into agreement.

Unemployment Compensation—State Laws and Regulations

As stated in the beginning of this paper, it is not proposed to report on a detailed analysis of the forms, definitions and procedures incident to the collection of taxes and the payment of benefits under the 51 state unemployment insurance laws.

Contribution (Tax) Returns. Taking up first the tax reports (usually referred to as contribution reports), we find a wide range in the information required for such reports. The less complicated reports require the number of employees, the total taxable wages and the computation of the tax which applies the 2.7% tax rate to the taxable wages, plus or minus adjustments for over and underpayments and the addition of interest on delinquent payments. The most complicated reports require separate filings by location of establishments; a breakdown of the wage data and the number of covered workers by payroll periods; employment data in respect of accessions and separations and an analysis of separations by reasons, as well as provision for adjustments and interest. The New Mexico form is illustrative of the less complicated form and the Alabama form of the most complicated.

Since the less complicated contribution report meets the requirement for the collection of the tax, it is pertinent to inquire as to why the necessity for the additional data which are unduly burdensome on employers and may even militate against the collection of taxes. The only apparent answer to this question is that it may be desired to use the contribution report for the collection of statistical data the use of which is extremely doubtful at this time. I do not mean to imply that necessary statistics should not be gathered on the collection reports. In this category I would include such items as the number of covered employees which are probably necessary to determine the actuarial solvency of the funds, to test the reasonableness of administrative expense from one angle and which have other possible uses. Beyond the requirements of minimum necessary data, it would seem desirable to postpone the collection of further data to a future date and consideration given to the use of separate reports at frequent intervals rather than currently requiring the data on tax or collection reports.

The regulations or instructions of some state agencies do not permit employers to make adjustments of previous overpayments or under payments without first applying for and obtaining credit or debit memoranda. Under title VIII of the social security act and related regulations, employers are permitted to make adjustments of errors without the formality of filing a claim for refund or credit of an overpayment and without formal demand by the collector in case of an underpayment. Adjustments of previous underpayments or overpayments may be made by employers on Form SS-1a accompanied by a statement explaining the reasons for and details of each correction. This is, of course, a much simpler method of handling adjustments both from the standpoint of the state agencies and employers. A few of the laws which contain no provision for adjustments and refunds should be amended to include such a provision.

As to the frequency of tax reporting and collections, it might be noted that all of the original laws or regulations required monthly reporting. Payments were due within the month following the reporting month. Some demand for less frequent collections was made last year but it was not until 1938, after the bureau of internal revenue established the combined tax and information return for old-age insurance taxes on a quarterly basis, that the board permitted states to adopt a quarterly tax return. At the present writing, 18 states have continued the monthly collection, with 29 states going over to a quarterly basis, and 4 permitting quarterly payments on approval of the state agency.

It would appear that quarterly reporting with the payment due by the end of the following month is frequent enough, although the provisions of the law should give the state commission authority to

require payments more frequently in the case of employers who have been delinquent.

Information Returns. The combined quarterly tax and information return established for old-age insurance raises the question as to the desirability of the same sort of return for unemployment insurance contributions, with the next step looking toward uniformity between the two reports to the end that a carbon copy of one will suffice for the other. Before passing on this question it would be well to note the different requirements for which the information returns are needed. Under old-age insurance, annual earnings up to $3,000 paid by an employer to an employee, for every covered employee after January 1, 1937, is necessary to the determination of benefits. Under unemployment insurance usually only the last five or nine quarters prior to unemployment are necessary to the determination of benefits for those only who become unemployed and qualify for benefits.

Information returns as to wages earned by covered employees are usually required for *all employees* quarterly, *many* states using lists on which wages for 20 or more employees are itemized. Some of these information returns are necessary for the payment of benefits but since many and probably a majority of employees will never draw benefits, the question naturally arises as to the necessity for requiring information returns except for those who are potential claimants. Nine states, including the District of Columbia, allow qualified employers to report on a so-called "separation" basis. This is desirable not only from the standpoint of employers but more especially from the standpoint of the state administration.

Even if it were found absolutely necessary to obtain wage data for all employees, no sound reason can be found to support the collection of such data on lists as distinguished from separate slips for each employee. The former requires processing for each employee, whereas the latter permits of filing by account numbers to be further processed only when a claim is filed. Some employers have stated a preference for the use of lists and current reporting for all employees. This group includes those who use certain types of machines for payroll work. However, since employers are also taxpayers they should be interested in the combined expense of employers and the administration. Perhaps the best answer would be to make it optional with qualified employers to file (a) complete separation wage data for employees separated or current quarterly reporting for all covered employees, and (b) the use of lists where it can be established that it is more costly to the employer to use slips than can be saved to the state in processing from lists.

Experience in the Payment of Benefits under the Present Benefit Formula. Under the present laws an unemployed worker must have worked a given number of weeks or must have earned a certain number of times his weekly benefit rate in the base period to become

eligible for unemployment benefits. The base period is usually the first four of the last five, or the first eight of the last nine, completed calendar quarters prior to unemployment. The weekly benefit rate is usually 50% of the full-time weekly wage or 1/26th of the highest quarterly earnings in the base year. The maximum benefits a worker may draw during a benefit year is usually the lesser of a fixed number of times (varying from 12 to 20) the weekly benefit rate or a fixed percentage of his wage credits during the base period (usually about 1/6th of annual earnings). The benefit year is usually the 52 consecutive weeks beginning with the first compensible week and thereafter. All of the foregoing constitute what might briefly be referred to as "the benefit formula."

As previously mentioned, 22 states began the payment of benefits on January 1, 1938. Much could be written concerning the difficulties and the delays in making benefit payments and in the lack of understanding on the part of beneficiaries as to what their rights were. Most informed people, it is believed, are of the opinion that the experience in connection with the payment of benefits points to the benefit formula as being the source of most of the difficulties. Mr. George E. Bigge, member of the social security board, in a talk delivered before the Institute of Public Affairs at the University of Virginia on July 11, 1938, summed up this situation as follows:

> ". . . I should like to say that none of us, either of the state agencies or of the social security board, are satisfied with our present structure. We are fully aware of its shortcomings. It is too complex, too cumbersome, and likely to prove too expensive. Since the state laws are the ones which embody the substantive provisions, the necessary changes must be made there."

Proposal for Simplification of the Benefit Formula

In considering what changes in the laws are necessary to a simplification of the benefit structure, it appears desirable to first set forth the objectives. These might be summarized as follows: A benefit formula, to be efficiently and economically administered, must be such as to permit the average covered worker to determine whether or not he is eligible for benefits, and if he is eligible, what his weekly benefit rate is and the maximum benefits to which he is entitled. Such a benefit structure must avoid, as far as possible, special determination in individual cases requiring the exercise of competent judgment, thus permitting processing in bulk which is necessary to both an efficient and economical administration. Lastly, a simplified benefit structure is one that requires a minimum of record-keeping and reporting by employers.

The use of "full-time weekly wages" as a base for benefits has proven to be unworkable. Many of the state laws have a benefit structure basing benefits on a percentage of full-time weekly wages with an alternate provision that if such determination produces results which are arbitrary, unreasonable or not readily determinable, the full-time weekly rate is to be 1/13th of the highest quarter's earnings in the base period. Several of the 22 states paying benefits have already adopted the alternate method of basing benefits on 1/26th of quarterly earnings in lieu of 50% of full-time weekly wages.

The use of the highest quarterly earnings as a base for benefits has simplified the earlier laws which required data of time worked and wages by weeks. As a substitute for the so-called "full-time weekly wage" it may produce higher weekly rates where the worker has had full-time work with some overtime and lower rates where the worker has not had the equivalent of full-time work. It does not result in giving those workers who have a high hourly rate but rarely work full time, as high a weekly rate as those whose income is the same but whose work is more steady. This, however, is not to be considered as a detriment to the use of earnings because it removes what many consider to be an unfair advantage under the full-time weekly wage formula. Both the full-time weekly wage and the highest quarterly earnings benefit those workers engaged in businesses which are subject to seasonal swings, by giving them a high weekly benefit rate. On the other hand, and because the maximum is usually controlled by total earnings in the base period, those who benefit in a high weekly rate may draw benefits for a shorter period.

In order to overcome the disadvantages under present benefit formulae and having in mind the general objectives previously outlined, the following formula is suggested:

> For eligibility, weekly rate, and maximum duration of benefits use the actual earnings in the base calendar year with the benefit year to be a fixed fiscal year following the base calendar year with a lag of three or six months. To further simplify this formula, weekly benefit rates should be paid in multiples of 50 cents or $1.00 with corresponding wage-earning groups which will produce in the aggregate the same amount of benefits now being paid. Since the weekly rate is based on annual earnings, the maximum may be fixed at a single control, viz., a fixed number of weeks.

The above formula may then be reduced to a simple table for ease of understanding on the part of the beneficiary and ease of administration. A suggestion for such a table appears as Table A. This particular table fixes $126 as the minimum of earnings during the base calendar year, which will qualify an individual for benefits.

It is more liberal than the present eligibility requirements which may exclude some workers who have a high weekly rate whereas other workers with the same earnings in the base year qualify because of a lower rate.

TABLE A

Wage class (*Column A*)	Wages in base year (*Column B*)		Weekly benefit rate for total unemployment (*Column C*)	Maximum benefits in benefit year for total and/or partial unemployment	
				Weeks (*Column D*)	*Amount* (*Column E*)
1	$1,350 or over		$15.00	16	$240
2	1,300 to	$1,349.99	14.50	16	232
3	1,250	1,299.99	14.00	16	224
4	1,200	1,249.99	13.50	16	216
5	1,150	1,199.99	13.00	16	208
6	1,100	1,149.99	12.50	16	200
7	1,050	1,099.99	12.00	16	192
8	1,000	1,049.99	11.50	16	184
9	950	999.99	11.00	16	176
10	900	949.99	10.50	16	168
11	850	899.99	10.00	16	160
12	800	849.99	9.50	16	152
13	750	799.99	9.00	16	144
14	700	749.99	8.50	16	136
15	650	699.99	8.00	16	128
16	600	649.99	7.50	16	120
17	550	599.99	7.00	16	112
18	500	549.99	6.50	16	104
19	450	499.99	6.00	16	96
20	400	449.99	5.50	16	88
21	350	399.99	5.00	16	80
22	300	349.99	4.50	16	72
23	250	299.99	4.00	16	64
24	200	249.99	3.50	16	56
25	150	199.99	3.00	16	48
26	126	149.99	2.50	16	40
27	Under $126		–0–		–0–

The key to the table is the wage groupings shown in Column (B). The particular groupings shown in Table A were based on a study of between 1,000 and 1,500 actual cases in a state which bases its benefits on the highest quarter's earnings. These wage groupings

produce in the aggregate slightly less weekly rates but would pay more in the maximum if all employees continued unemployed. Data were not available as to the actual time the individuals continued to draw benefits but it was felt that the aggregate payments under the two formulae would be approximately the same. Some smoothing out was necessary but it was accomplished without any one group deviating as much as 10%.

Benefits for partial unemployment are now provided for in some laws but not in others. Theoretically an unemployment insurance plan should provide for partial benefits for two reasons. First, it removes the temptation to workers to withhold information about casual or temporary employment when they are otherwise qualified to receive benefits for total unemployment. Second, it removes inequalities in benefit eligibility which grow out of the policy of the employer to meet a falling-off in demand and which is not subject to any control by the workers. This refers to whether reductions are made by part-timing or by working alternate weeks, etc. On the other hand, considerable administrative difficulty has been encountered in connection with the payment of partial benefits. Some of the states require weekly reports of low earnings from employers, to which employers are objecting. Others require the employer to give the employee a statement of his earnings when they fall in the low-earning category. Fitting the benefit week into the employer's pay periods is causing considerable trouble. Many checks are being written for small amounts which is very costly. No immediate answer seems to overcome all of the disadvantages from the administrative angle without introducing disadvantages from other angles. One group has suggested that partial benefits be determined and paid in relation to quarterly earnings.

Table B, reproduced herein, in brief illustrates a tie-in of quarterly partial benefits with the above suggestions for total benefits. It is so designed that no waiting period is required; it permits of the employee drawing total benefits for any weeks within the quarter for which he so qualifies (in which case the number of weekly checks payable for total benefits is to be deducted from the number payable on the table); and introduces a money incentive for the worker to accept temporary or casual employment. While the table at first glance appears complicated, it permits of easy explanation to the worker. To illustrate, say an employee having earned $1,275 (average $24.50 weekly) in the base period, earns $195 in a given quarter (averaging $15.00 a week). Referring to line 2 which is his wage group and matching $195 earned with Columns (D) to (M), we find the next highest earnings in Column (E) which entitles him to quarterly benefits equivalent to two weekly amounts for total benefits. If the reduction in earnings was due to a period of five weeks in which there was no unemployment, he could have qualified for two weeks of total benefits after the waiting period

(assumed in the table to be three weeks). Actually he would not be entitled to any partial benefits. But if the reduction in earnings was due to part-timing so that there were no weeks of total unemployment, he would draw benefits in the same amount as partial benefits.

No opportunity has been had to test out this table with partial benefits now being made. Since there is no particular magic in the figures shown in Columns (D) to (M) on the table, they should be given such a test. This test, however, should follow any that might be made in connection with the wage groupings in Table A inasmuch as these wage groupings are carried forward to Table B.

Proposal for Simplification of Merit-Rating Administration

Since merit-rating or "experience-rating" as preferred by many is the subject of some controversy, I want to make my position clear at the outset. I belong neither to the group that is in favor of experience-rating nor to the group that is opposing it. If there is to be experience-rating I am anxious that it be such as can be administered efficiently and economically and that the schedule of rates is such that in themselves they will not make the funds insolvent in a short time after they become effective.

TABLE B

Quarterly Benefits for Partial Unemployment

Wage class	Wages in base year	Weekly benefit rate for total unemployment	Earnings in calendar quarter below which the worker is entitled to the number of weekly checks for total unemployment as indicated			
Col. A	*Col. B*	*Col. C.*	*Col. D*	*Col. E*	*Col. L*	*Col. M*
1	$1,350 or over	$15.00	$225.00(1)	$202.50(2)	$45.00(9)	$22.50(10)
2	1,300 to $1,349.99	14.50	217.50(1)	195.75(2)	43.50(9)	21.75(10)
3	1,250 to 1,299.99	14.00	210.00(1)	189.00(2)	42.00(9)	21.00(10)
25	150 to 199.99	3.00	42.00(1)	39.00(2)	9.00(9)	4.50(10)
26	126 to 149.99	2.50	29.00(1)	26.50(2)	7.50(9)	3.75(10)
27	Under $126	0		0		

Note: This table, which is incomplete, has been briefed in order to conserve space.

While many state laws have provisions for so-called merit-rating, there is much doubt as to whether any have developed an efficient and economical method for administering these provisions. The federal law requires, where merit-rating is based on separate employer reserve accounts, cumulative statements of contributions less benefits to former employees, of each employer in order to determine the ratio of reserve balance to payroll, which ratio controls the rate.

Where the pooled type of fund is provided in a state law, most of the laws require that employers' accounts be set up, as the rate depends on the ratio of the balance in the employer's account to his payroll. However, the only requirement of the federal law with respect to contributions to a pooled fund is that lower rates are permitted on the basis of not less than three years of benefit experience.

Looking at this problem from the administrative side, the pooled type of fund lends itself to shortcuts which could not be had under the employer's reserve type of fund. However, some means must be found to avoid the necessity of accounting for each benefit check by employers if the administration of merit-rating is to be accomplished on an efficient, economical and sound basis. Such further simplification may be had by the use of a formula which makes an initial charge to the employer of the "benefit wages" paid during the base year to each unemployed worker who receives an initial benefit, the initial charge being paid at the time the initial benefit check is issued. The ratio of the "benefit wages" of each employer to his total taxable wages for the year or for a three-year period results in, what might be referred to as, the "employer experience factor." At the end of the benefit year the state would determine the ratio of the total benefits paid less the credits to the fund for interest and employee contributions, to the aggregate of the "benefit wages" for all claimants drawing benefits during the benefit year. This ratio will be referred to as the "state benefit factor."

The tax rate for each employer effective for the following year will be obtained by applying the state benefit factor to each employer's experience factor, subject to any minimum and maximum rates that may be provided in the law. This formula, while appearing complicated, may be simply illustrated by the following which assumes that there are only three employers in the whole state:

	Employer A	Employer B	Employer C	State total
1. Total taxable wages	$5,000,000	$3,000,000	$2,000,000	$10,000,000
2. "Benefit Wages" [a]	2,000,000	750,000	100,000	2,850,000
3. Employer Experience Factor (2 ÷ 1) [b]	40%	25%	5%	
4. Total benefits paid				375,000
5. Less interest and employee contributions ..				90,000
6. Benefits chargeable to employers (4 — 5) ...				285,000
7. State Benefit Factor (6 + 2) for State) [b]..				10%
8. Employer's tax rate (3 × 7)	4%	2.5%	.5%	
9. Employer's tax for current year [c]	$200,000	$75,000	$10,000	$285,000

[a] "Benefit Wages" is defined as the wages in the base year for each worker who receives a benefit in the benefit year. Where there is more than one employer for any employee, the benefit wages for each employer is the amount which that employer paid to the employee in the base year.

[b] To the nearest full per cent.

[c] If payroll for current year is the same as for the previous year, the current rates will automatically replenish the fund for the previous year's net withdrawals.

In the illustration above, the employer experience factor is limited to one year. In order to avoid sharp changes in the rate from one year to the next year, items 1 and 2 may be placed on a moving three years' basis.

Here again a simple table may be employed to set forth the rate to fit any combination of employer experience factor and state benefit factor. Such a table is given herein as Table C.

In constructing this particular table it is assumed that a graduated scale of rates ranging in one-half of 1% steps between a minimum of 0.5% to a maximum of 4% is acceptable. It will be noted that the resulting product of the state factor and the employer's factor is adjusted to the next higher multiple of 0.5%. For instance, where the former is 12% and the latter 9%, the product would be 1.08%. In the table opposite the 12% state factor we find 8% and 13%, and since 9% is more than 8% but does not exceed the 13%, we take the latter column which provides for a rate of 1.5%. On the average, this adjustment adds one-fourth of 1% between the 0.5% and the maximum of 4% and this adjustment plus the increment where the product is below 0.5% will tend to offset those cases where the product will exceed the 4% maximum.

Data are not available to test this table, as should be done, to see that it will produce, on the average, what it is agreed should be

TABLE C

DETERMINATION OF EMPLOYER'S CONTRIBUTION RATE FOR UNEMPLOYMENT INSURANCE

When the state experience factor is	If the employer's benefit wage ratio does not exceed						*
1%	50%	100%	150%	200%	250%	300%	350%
2	25	50	75	100	125	150	175
3	17	33	50	66	83	100	117
4	13	25	38	50	63	75	88
5	10	20	30	40	50	60	70
6	8	17	25	34	42	50	58
7	7	14	21	29	36	43	50
8	6	13	19	25	31	38	44
9	6	11	16	22	28	33	39
10	5	10	15	20	25	30	35
11	5	9	14	18	23	27	32
12	4	8	13	17	21	25	29
13	4	8	12	15	19	23	27
14	4	7	11	14	18	21	25
15	3	7	10	13	17	20	23
16	3	6	9	12	16	19	22
17	3	6	9	12	15	18	21
18	3	6	8	11	14	17	19
19	3	5	8	11	13	16	18
20	3	5	8	10	13	15	18
21	2	5	7	10	12	14	17
22	2	5	7	9	11	14	16
23	2	4	7	9	11	13	15
24	2	4	6	8	10	12	15
	The employer's contribution rate shall be:						
	.5%	1.0%	1.5%	2.0%	2.5%	3.0%	3.5%

* If the employer's benefit wage ratio exceeds the amount in the last column of the table on the line for the current year's state experience factor, his contribution rate shall be 4%.

produced. If it is desired that the schedule should produce an average of 2.7% and the tests cannot be made to prove this, it would be in order to provide that the rates shown in the table be used as test rates subject to an adjustment pro rata which will produce in the aggregate 2.7% of the total taxable payroll for the state. Another item for consideration is the possible minimum and maximum rates. Provision might be made so that the rate under no circumstances should fall below the minimum. Also provision might be made so

that the adjustment should not increase the maximum beyond an agreed rate, in which case the difference should be prorated over the rates below the maximum. The final specifications on which the table is to be built should be drawn up in conference between interested parties, viz., Administration, Employer and Employee representatives.

Conclusion

Obviously this paper, lengthy as it is, has only touched the major points. Many minor items could be dealt with, such as the so-called contractor provisions, employment provisions, interstate employment, the treatment of dismissal or termination payments in the tax base and for benefit purposes, etc.

In making the proposals for simplification which have been outlined above, I have been motivated only by a desire to have the social security laws administered efficiently and economically. It is my considered opinion that if substantial changes looking toward a better understanding of the rights of beneficiaries and a simplification of administrative procedures are not made in the state laws, the future of social security may be seriously jeopardized.

Chairman Blough: Mr. Gretz mentioned statistics a while ago. You all remember, I suppose, what Will Rogers had to say about statistics. Will said, "You know, statistics are like garbage. You should never collect them if you don't know what you are going to do with them."

The second of these technical reports is prepared by Professor Haber, of the University of Michigan, consultant for the social security board, who is also a member of the committee.

Professor Haber had hoped to be here tonight but a conflicting engagement made it impossible, and with your indulgence I will read his paper. His paper is, "Merit Rating in State Unemployment Compensation Plans."

MERIT-RATING IN STATE UNEMPLOYMENT COMPENSATION PLANS

WILLIAM HABER
University of Michigan

The brief American experience with unemployment compensation indicates that serious problems of administration have come to light since January, 1938. These problems are in part the outgrowth of complicated legislative provisions, particularly in regard to (1) the benefit formula and (2) merit-rating provisions in the state laws. While financial solvency does not appear to be one of immediate importance, as attested by the substantial balances in the state funds, these balances are not uniform among the states and several state

funds may be in serious condition in a short time. Administrative costs are higher than had been anticipated and provided for in congressional appropriations.

The American unemployment insurance laws differ from the European models primarily in providing that the employer's tax rate shall vary with his ability to stabilize employment. In twenty-seven states some type of merit-rating will operate automatically after a certain date; in nine other states, provision is made for a study of merit-rating and the recommending of legislation. The principle of merit-rating is borrowed from workmen's compensation legislation. It is founded upon the premise that, if given adequate incentive, the employer will stabilize employment and reduce its fluctuations. This is not the place to examine the soundness of the various aspects of this theory: whether the workmen's compensation analogy is applicable; whether an additional incentive is needed to induce employers to stabilize; whether the payroll tax differential of approximately 2 per cent is large enough to provide such an additional incentive; whether, in view of the probable incidence of the payroll tax, it can in fact serve as any incentive at all; or whether the employment of the principle has any place in a social insurance scheme, are all important theoretical problems. Their discussion may throw light on the soundness of the merit-rating principle, but they need not be considered here.

Whatever may be the merits of this principle in the theory of unemployment compensation, its inclusion in so many state laws is likely to create several serious administrative problems, and may possibly endanger the availability of the benefits which these laws are presumed to provide. Special requirements in merit-rating provisions have already introduced many serious accounting problems, although in some states the accounting problems are relatively simple. In Michigan, for instance, the weekly benefit is charged to the account of the last employer only. The equity of a "charge-back" *only* to the last employer may well be disputed, but its administrative conveniences certainly justify it. The mere bookkeeping requirement is thereby reduced considerably, although it is still no inconsequential operation with benefit entries to be made for as many as 500,000 different individuals in any one year.

In other states, however, the process is considerably more complicated. In Wisconsin, the charge-back is made to the last three employers in inverse order as the balance in the account of each becomes exhausted. Under the California law, the charge-back is applied against all the employers in the base period proportionately and simultaneously. Thus, if a worker receives $16 per week in insurance benefits and has had four employers in the two years immediately preceding his application for insurance, each of his former employers is advised of his claim and each of these four accounts is debited for one-fourth of the weekly check, or $4, for

each week during which benefits are paid. Other variations, more or less complicated, prevail. Thus, merit-rating may result in a top-heavy administrative structure involving huge staffs and great expense. The cost of operation may well exceed the 10 per cent contemplated; in some states it is already above 15 and nearly 20 per cent. (The administrative overhead in Great Britain, with a national plan, flat rate benefits, and none of the specialized features current in the American laws, is less than 10 per cent.) If the problem were merely one of accounting and charge-back, the difficulties would not be insurmountable. Simplification could be effected by use of the Michigan system and by discarding individual employer reserve accounts and setting up such accounts on an industrial basis.

A second problem which is raised by merit-rating concerns its possible influence upon the solvency of the state funds and the effectiveness of the insurance principle. The reduction of the contribution rates of employers who succeed in maintaining their "reserve ratio" will leave a residue in the insurance pool only of the poorer risks. The state laws do not penalize the failure to the same degree that they reward the success of stabilization. Whereas the successful employer is rewarded by a reduction in his contribution from 3 per cent to 1 per cent, or, as in some laws, to no tax at all, the employer who fails to stabilize is not subject to an additional penalty which would increase the fund to meet the extra heavy demands resulting from such failure. To correct this, it is necessary to have as wide a variation in rate of contribution above 3 per cent as is provided below it. In addition, the existence of laws which make it possible for the employer's rate to fall to zero is not justified, since every employer is responsible for some unemployment, even though unemployed workers are unable, due to the specific eligibility requirements, to qualify for benefits from their employers' accounts.

An additional problem is presented in those states where a considerable percentage of the workers may be employed by one employer or a small group of employers. In Delaware, for example, if the largest employer "stabilizes" and ceases to pay any tax into the insurance fund, the fund would decrease by as much as 20 per cent or 25 per cent. The relatively stable employer having thus withdrawn his contribution, the fund would be exposed to a heavy drain from the less stable industries. It is possible, also, for "stabilization" to be defined narrowly as a method of so apportioning working time as to make the employees ineligible for benefits. In Michigan, for instance, employers have been urged to arrange lay-offs, inventory-taking periods, and short-time work in such a manner that the individual employer's fund will not be adversely affected, even though the worker incurs considerable lost time.

Merit-rating can partly destroy the advantages of a uniform tax upon the employers in all states. Title IX of the social security act removed the argument of interstate competition before state laws were passed. All employers were subjected to a 3 per cent payroll tax whether the state in which they operated had an unemployment insurance law or not. Merit-rating may, in part, reintroduce the disadvantages of tax differentials among competitors in the same or different states. One employer may pay a tax of 1 per cent or no tax at all, while his competitor in another state may pay as high as 4 per cent. There will thus be a tremendous pressure to cut rates and to equalize the competitive burdens between the states.

Much experimentation with merit-rating will no doubt continue. To contribute to the theory and practice of unemployment insurance, merit-rating provisions should include penalties for failure to stabilize as well as rewards for succeeding. Above all, simplification in administration is vital. It may be possible to introduce variation of rates by industries on the basis of an employment index, thus making unnecessary the costly process of charge-back to each or to all employers. Unless merit-rating can be simplified, and unless it can be employed without endangering the solvency of the funds, its history will be very brief.

From the viewpoint of the major objective, the provision for the unemployed, merit-rating has little justification in a system of unemployment insurance. Such incidental stabilizing effect that it may produce would be confined to unemployment caused by internal mismanagement and abnormal labor turnover. It would be confined largely to seasonal industries. These advantages are more than outweighed by the dangers which are inherent in the merit-rating principle in unemployment insurance. Restated, the criticisms of merit-rating are:

1. Reduced tax rates under the present plans are not offset by similar rate increases. This may impair the solvency of the state unemployment compensation funds.

2. The complex formulas of present merit-rating plans greatly increase the administrative costs of unemployment compensation.

3. On an individual state basis merit-rating nullifies whatever uniform tax base had been set up by Title IX of the social security act and reintroduces interstate competition in compensation laws.

4. Evidence already indicates that merit-rating has resulted in the development of lay-off and employment practices which are undesirable from a social point of view—such practices are inspired by the desire of employers to protect the balance in their account in the state unemployment compensation.

5. Under present formulas employers may obtain rate reductions—by confining their total employment to less than their full force—i. e., by causing unemployment rather than stabilizing employment.

6. Reduced rates under the present plans, since they are not off-set by similar increases may impair the solvency of state unemployment compensation funds.

7. Merit-rating has resulted in establishing in the present state laws future contribution rates in advance of experience, without any pretense at actuarial soundness.

CHAIRMAN BLOUGH: I have just finished reading Professor Haber's paper, and now with your permission we will proceed to the report of the committee, which I promise you will not be as long as it was last year. As a matter of fact, it will be just fifteen minutes long.

REPORT OF THE NATIONAL TAX ASSOCIATION COMMITTEE ON SOCIAL SECURITY

ROY BLOUGH, CHAIRMAN

Last year at the Baltimore conference your committee laid about with a rather sweeping flail in discussing what appeared to be the most important fiscal issues of legislative policy involved in old-age benefits, unemployment compensation and public assistance which are commonly joined in the public mind as the social security program. In anticipating the present report the consensus of persons consulted was to the effect that emphasis should be placed on administrative problems. The committee was enlarged and strengthened by the appointment of additional persons having a direct knowledge of administration from the viewpoints of government and taxpayers. The committee held two meetings, the first at Washington in May at which possible aspects of the subject were discussed and a decision reached to emphasize especially the problems of (1) merit rating in unemployment compensation, and of (2) tax definitions, forms and procedures both in general and specifically in the field of unemployment compensation. One or two other questions were approved for study but need not concern us here. Certain members of the committee kindly agreed to prepare preliminary drafts in the fields of their special interest and competence, and certain of these were received and circulated for comment.

The second meeting of the committee was held yesterday, although unfortunately only six members are in attendance at the conference. In the discussion of the preliminary reports before us as the basis for the committee's report, it was found that while there was no substantial disagreement, there was a rather general feeling that the committee as a whole lacked the necessary technical knowledge to arrive at intelligent decisions on the highly complicated administrative questions involved. Accordingly, it was decided to have the authors of the preliminary drafts present them to the con-

ference tonight as papers. You have just heard these excellent papers by Mr. Gretz and Professor Haber. They represent the approach of recognized experts to their problems. For the committee and for myself as chairman, I wish to express our very deep appreciation to these fellow committee members for their contributions. Our debt is especially great because although not members of our association and not primarily interested in taxation, they have nevertheless willingly assisted us.

In considering these drafts at yesterday's committee meeting it was felt that the thought of the committee and the conference might be clarified with regard to future approaches to the subject of social security finance, as well as to certain other types of problems to be mentioned later, if some attention were given in this report to the complications met by the committee in its attempt to fulfill the somewhat sweeping and not too precise mandate of the conference and the executive committee.

Committee assignments have usually been concerned with some particular tax or taxing device, which was to be analyzed from such viewpoints as equity, administrability, economic effects, and relations among taxing divisions or governmental levels. More rarely and perhaps very rarely until recent years, the committees have dealt with expenditures in general and more particularly expenditure control. Social security, however, is not a taxing device nor a method of reducing taxes; it has become a series of more or less coordinated social policies directed to reducing some of the economic risks that are met primarily by the lower income groups both urban and rural, which risks have become major problems in our industrialized society. As a major development in governmental functions, and a very expensive one, it was of obvious interest to everyone concerned with fiscal policy. The introduction of any expensive, new public service is bound to make important demands on taxing devices and to have important repercussions on other services. To this general interest was added the fact that the social security act of 1935 introduced the payroll taxes into the federal tax system, and by force of example and economic pressure into state tax systems. A substantially new timing device for relating taxes and expenditures, namely the reserve for old-age benefits, as well as the less significant reserve for unemployment compensation, were also introduced. There can thus be no doubt that the social security act was and is of great interest to tax students, practitioners and policy makers. However, taxation was merely a means to an end, so that the tax aspects of the social security program were not its most important aspects.

Your committee quite obviously was not in position to pass intelligent judgment on the social security program and concluded that it was not expected to do so. True, taxation was one consideration in determining the desirability of that program, but the

fundamental balancing of social cost against social benefit was larger than tax considerations. The committee accordingly confined its attention to the fiscal problems involved in social security legislation, as an examination of reports presented at the Indianapolis and Baltimore conferences will reveal. As previously suggested, those reports dealt with legislative policy and not with administration. Because taxation was only an aspect of the whole problem, the conclusions reached by the committee were necessarily highly tentative and conditional, since a course of action that was less than happy from a tax viewpoint might become mandatory for other reasons. This was unsatisfactory for a committee report, but we hope was intelligible.

In considering the administrative aspects this year, the segregation of the subject into fiscal and other aspects, with attention only to the former, broke down. It would be of small value to suggest administrative procedures from the fiscal viewpoint when the force of other circumstances required the substitution of completely different ones. For example, in considering the desirability of a certain form of reporting of payroll taxes for unemployment compensation, a main factor was found to be the need for such reports in the payment of compensation. Thus what started as an examination of tax administration was soon found to be involved in the administration of unemployment compensation. Similarly, although the question of merit or experience rating for determining unemployment compensation taxes involves certain rather profound questions of fiscal policy, perhaps the most basic factor in reaching a decision as to its desirability is the possibility of administering the payment of compensation under merit rating, which again is not taxation.

Further examination of the administrative question revealed another interesting fact. In all but one or two states, unemployment compensation contributions or taxes are not administered by tax commissions or other usual collecting agencies, but by the bodies that administer the expenditure of the funds. Among taxpayers also the work connected with social security taxes has to a very considerable extent been placed in other hands than those dealing with tax matters generally. Accounting, payroll, and personnel people have seemed nearer the social security problems of employers than have tax practitioners. Thus, at least so far as unemployment compensation is concerned, the administration has been concentrated in the hands of those concerned with the payment of compensation rather than of those concerned with governmental finances.

It is also not without significance that among the 24 members of the senate advisory council on old-age insurance there is no one to whom taxation or public finance is a major interest. The obvious inference is that whatever tax specialists may think of social security, tax policy is a minor concern of those interested in social security.

We cannot be too happy with this state of affairs since tax considerations should be powerful ones in deciding issues where tax administration and the distribution of tax burdens are such significant factors as in this case. Perhaps it is our own fault since tax specialists have ordinarily kept pretty closely within the narrow confines of their own bailiwick.

Although recognizing that this narrowness has perhaps kept tax specialists from playing a more significant part in the determination of public policy in general, the committee is not prepared to recommend that the National Tax Association should enlarge the scope of its interests. Distraction and dispersion of effort would inevitably follow.

It may not be amiss to point out that the same type of logical problem met by this committee will almost certainly arise in the future and perhaps more frequently than in the past. Taxation is being used for other than revenue purposes. If the signs of the times are significant, it is likely to be so used increasingly in the future. The members of this committee are probably not agreed on the desirability of such use. However, in so far as it has been possible to consult the members of the committee, we do agree in the belief that committees of the National Tax Association will have great difficulty in appraising the desirability of any particular tax measures imposed for social control purposes, since not only the tax effects will be at issue but also the desirability of the social end to be accomplished. Perhaps some technique of combining tax specialists with those representing the social purpose to be accomplished can be worked out. Certainly the tax man should not abdicate nor allow himself to be shouldered out of the picture when such policies are under consideration. How the National Tax Association can successfully deal with such situations is a problem for which we do not suggest an answer.

Tax issues in social security are likely to increase in importance in the future. The Townsend plan had a tax measure as one of its basic elements. The "$30 Every Thursday" plan is in essence largely a tax measure. Coming down more nearly to earth, proposals are being seriously considered to extend the coverage of the old-age benefits to include farm and domestic labor and possibly self-employed groups. If such extension takes place, the administrators of the taxes may face difficulties of a type with which we have little experience as a nation, save possibly in the taxation of intangibles. The significant point here is that adoption of such taxes is being pressed by considerations of broad social character which may outweigh—and perhaps quite properly so—the objections that tax administrators may raise.

The end product of a committee is presumably a recommendation of policy. In a field where taxation is only one consideration in the determination of the policy, and frequently a minor considera-

tion, a committee has difficulty in arriving at a successful statement of policy, as it likewise has where difficult administrative techniques of a non-tax character are involved.

Perhaps the answer is that on such matters no attempt should be made to recommend policy within the bounds of the National Tax Association but rather that at the conference each year or whenever significant developments occur, consideration should be given through papers and discussions to the fiscal aspects of social security programs so that as individual members we may contribute more intelligently to the determination of policies that cannot be handled as fiscal matters alone.

Respectfully submitted,

ROY BLOUGH, *Chairman*
EWAN CLAGUE
ROGER F. EVANS
WALTER D. FULLER
ROBERT W. GAYLORD
CHARLES W. GERSTENBERG
HARRY C. GRETZ
HAROLD N. GRAVES
WILLIAM H. HABER
CLARENCE HEER
HARLEY L. LUTZ
A. J. MAXWELL
J. W. OLIVER.

CHAIRMAN BLOUGH: Mr. President, I would like to move that this report be accepted and the committee discharged.

PRESIDENT LELAND, presiding.

PRESIDENT LELAND: Is there a second to that motion?

PHILIP ZOERCHER (Indiana): I second the motion.

HENRY F. LONG (Massachusetts): Does that mean by acceptance that we will discharge the committee, or does it simply mean that the conference is glad to receive the report and enjoys having it brought before them, leaving it to the National Tax Association to determine as to whether the committee will be continued or not?

PRESIDENT LELAND: Well, your motion should be the one that is made, and with the consent of the chairman of the committee, we will consider his motion interpreted as Mr. Long has more correctly stated it.

Is there a second to the motion as interpreted?

MR. ZOERCHER: I will second it.

PRESIDENT LELAND: Is there any discussion? All in favor say, "Aye."

(Ayes.)

PRESIDENT LELAND: Contrary, the same sign.

(None.)

PRESIDENT LELAND: The committee report is accepted.

That doesn't mean that the discussion of the report is by any means closed, and the chairman will be glad to recognize anyone who cares to comment upon the discussion.

May I say that just before I came in here I found a note from Mr. Oliver, who is a member of the committee, in which he says he is in accord with Mr. Gretz's paper, and also in accord with the proposal that the assignment is too all-embracing for a committee of this association.

CHAUNCEY B. ALLYN (Illinois): If I may, I would like to say a little bit about this merit rating, because there is one point I don't think was brought out in the very excellent paper.

As was brought out, though, the whole scheme of the plan has been based upon the theory that the charge against an employer which should be made is based on the employees who formerly worked for him, and not based upon the amount of employment contribution to the state by him.

I am in the grocery business, and this hits us very hard, because we maintain total employment. However, employees do not make a life-work out of being grocery clerks.

We have confused the matter of turnover of employees with stabilization of employment. Stabilization of employment is what we want to recognize, I would hope, in our merit rating, if we are going to have merit rating, and that should mean maintaining total payrolls, or total number employed.

I just wanted to bring that out.

LEO MATTERSDORF (New York): Mr. Chairman, I think the papers submitted here tonight were very excellent. I would like, if the committee is continued, to ask them to consider a proposal that was made by a committee, of which I had the honor to be a member, to the New York authorities. It may be that the proposal was a little too simple—I don't know; that is, simple in the sense that it may not work out in practice in a number of states.

One of the difficulties, it seems to me, with the unemployment insurance laws, is the difficulty of reporting; and then of the computation of benefits. In the computation of benefits you can subdivide the difficulties, again, into the individual computations on the one hand; and, secondly, the contention is made by the beneficiaries that they are not getting the amount to which they are entitled; the first, of course, being a state problem.

As I understand it, a number of the states, when they obtain the information which is listed on the papers or the reports, names,

numbers, amounts, and so forth, punch that information on punched cards. The punched cards are later used for classification of statistics, running them through the machine to determine benefits, and so on.

The proposal to which I had reference was that when these reports came in, the punched cards be used for one other purpose, and that is, to immediately print receipts. That is possible in this punching machine; at least, it is in one type that I know of. The receipts should then be sent back in bulk to the employer, who would distribute them to the employees.

You have the advantage there that every employee knows he has to get one of these; secondly, that it is a self-auditing process, since he will not be heard later to complain that the tax was not correctly paid, that his employer paid on too small an amount. It will to a great extent prevent avoidance, or rather, evasion, of the tax entirely. Then, when it comes time for him to claim a benefit, if he hasn't retained the slips, at least if there is a provision in the law that he has a certain period of time after he receives them to make a complaint as to the amount, he can not be heard to say that his benefits are incorrectly computed or computed on the wrong amount.

This will prevent what has happened in New York; namely, having to wait weeks and weeks for his benefit check. I don't say it will prevent it altogether. It will prevent it to a great extent.

Certainly, it also seems to me that states like New York and others in the same category should follow the federal old-age pension form and split the form, computing the tax on the same form. That will prevent administrative difficulties which always arise, in that the totals shown on the information return often do not agree with the amounts on which the taxes were paid in the various months.

Another simplification which would certainly tend to reduce the cost of administration, again, is to have reports less frequent, even, than four times a year. If the committee is continued, I certainly wish it would consider that thought, for the reason I think it has the merit of preventing administrative costs from running away with the fund.

Thank you.

Franklin S. Edmonds (Pennsylvania): I would like to ask Mr. Blough a question arising out of the motion he made at the end. Isn't the money that is paid in for the unemployment insurance used for the ordinary expenses of government, and, if so, why, then, does it not become an appropriate fiscal plan for consideration by association?

Mr. Blough: I certainly don't mean to indicate that I don't consider any of these matters as proper for the consideration of the association or its committees. All I am trying to point out is that

when we tried to tackle this whole question as a committee we found that for a while we could go along very well by separating out the financial part and the non-financial part. We would say now, on the basis of financial considerations, this is what ought to be done, but, of course, we don't know about the other considerations. Maybe they are more powerful, and in that case we would have to withdraw.

Then when we got into administration, we found we were completely lost, because the non-tax aspects of administration were all mixed up with the tax aspects, and it was quite impossible to separate them. So it was more because of the great difficulty of the committee's work and the fact that as tax people we didn't feel qualified to pass on the general social aspects of the question that I made the suggestion at the end of the paper.

I don't mean to dodge your original question. I think the facts are very clear, just as clear as they can be. That is, take the question of the old-age payroll taxes, which are generally considered to be, and are being, handled as if they were collected for the payment of old-age benefits. Those taxes are turned into the general treasury, and there is turned over to the old-age reserve account an equivalent amount of federal securities, bearing somewhat higher, at the present time, than the going market rate on those securities.

The situation, then, is substantially the same as if the government had gone out into the open market and borrowed the money and used it; in other words, it is borrowing from the old-age reserve account.

It seems to me the interpretation of whether that is using the money for current purposes or not is one which is relatively fruitless when we come to argue about it. Some say it is and some say it isn't. It is a little hard to see how any other use of the money would be particularly better than that use. That is the problem that seems to have been faced, because what else can you do with the money? I am assuming you raise it at all; what can you do with it?

You can't keep it in cash, because you would ruin the monetary system of the country. If you bought the securities of private corporations, and so on, or municipalities, you would run into the question of the control of the federal government over private corporations, for example, and the old question of socialism.

Furthermore, assuming the federal government spent the same amount of money, it would necessitate the borrowing on the market of that money anyway, so that in economic effect you would have the same thing. We tried to go into that in our report last year. I think, if you recall, our general sentiment was opposed to the present plan of financing, but whether that constitutes a use of the funds for current purposes in a way that is to be condemned is something quite different.

I think most of the people who have investigated the subject carefully have come to the conclusion that if you are going to have taxes imposed before the expenditures are made, there is not much else that can be done with it other than what is being done at the present time.

That raises another issue — I don't want to get into this whole thing too deeply—but the persons who are urging the imposition of heavy taxes before the benefits are paid are stressing very strongly this point: that if we are not careful, we will expand our benefits and get ourselves into the position of having pledged the country to pay a volume of old-age benefits that it is not prepared to raise in taxes, and that the only way you can avoid that is to start raising those taxes before you start making the payments.

It is an extremely complicated question. We have all read hundreds of pages on it, and some of us have written nearly hundreds of pages on it. I am afraid that doesn't contribute very much to the discussion.

President Leland: I think that was an admirable answer to that question, Mr. Blough.

A. H. Stone (Mississippi): I think this is one of the most interesting discussions we have had, and I am sorry we didn't have it earlier in the conference. I started out with the thought that this has been an intensely interesting and very important discussion. I can't get away from the human nature of all these propositions. We discussed the theory, we discussed the methods of approach, and all the technical details. We raised questions, as Mr. Blough has raised them, with reference to the matter of whether or not we were going to commit the government to a program of benefit expenditures which cannot be met by any taxation device of which we have any knowledge right now. I am just wondering if we haven't already done that? If we haven't, we have done it by implication.

The history of taxation in this country is the history of the expansion of governmental services, government benefits. We have come into this proposition right now of old-age assistance, the whole social security program. The people who are going to receive this assistance and those who are going to politically profit by the granting of this assistance are going to take care of the proposition as to its increase. You needn't have any doubt whatever on that score.

I was a grown man thirty-one years after the civil war, before any politician in any state or any man who was inclined to a humanitarian aspect of public questions had the temerity to suggest any sort of a pension for an old confederate soldier. You will pardon me if I say that the reason for that was that down to that time, beginning with the close of the civil war and extending all the way through the reconstruction period and down to the time of which I speak, the thought of pensions was associated in our minds

with the granting of something in the way of benefits, governmental largess, to people who had been our oppressors, the people who had conquered us in war. The thought of giving an old confederate soldier a pension just didn't occur to anybody.

That is literally the fact. It was looked on with scorn. In other words, we thought we could heal our own wounds, we could take care of our own people. The families of these old soldiers took pride in the fact that a man who had worn the confederate uniform was never going to become an object of charity of the government or the public. They took care of them themselves.

It was 1896, as I say, thirty-one years after the civil war was closed, before the legislature of my state passed the first confederate pension act. That body was induced to do that, and they approached it very, very carefully and with a very great respect to these soldiers, with the attitude, "We don't want to insult you by offering you a pension, offering you an old-age benefit or anything that would look like we were trying to pay you for the four years you served in the confederate army."

It was found that there were some of the old soldiers who were indigent, whose people were poor, who had lost their relatives and were really suffering, and so $150,000 for two years was set aside for these men.

Here is where the human nature as applied to this thing came in. Whenever you once go into this field of social service, or, as far as that is concerned, whenever you consider the expansion of any of these governmental services, here is where you cannot separate them from the increase in the tax burden. That is what it means. One thing follows the other just as certainly as night follows day.

This $150,000 was very carefully administered, and it lasted more than the two years for which it was set aside. Forty years after that, when practically all of these old soldiers were dead, the appropriation for confederate pensions in my state for the same period of two years was $1,300,000. (Laughter)

What had happened? Well, the world had made progress—that is one thing that happened. It had gotten away from those old ideas of what the government was intended for. The civil war was 'way in the background. Why, they even got to the point where they pensioned the widows of confederate soldiers. They first started with the thought that it had to be a *bona fide* widow of a *bona fide* soldier. That meant that the couple must have been married when the civil war commenced in 1861.

After they became inured to the idea of accepting this little pension, and they finally got accustomed to it—they are just exactly like everybody else, you know, down there—they moved that up a peg and said, "We will not only pension these widows who were married in 1861; we will just move that up and pension all those who didn't get married until 1865."

That added, of course, quite a large number to the roll. It more than took care of the widows of the old soldiers who died. You can always count on that. People who are going to get these social security benefits will show you more tricks than you dreamed of before you are through. Not only you, but your successors, 100 years from now. They will still be working with it and still considering it, wondering why we thought it was worth while to come here and consider something that involved only five or ten billion dollars.

We moved up a peg from 1865 and got to 1870, and as more of the old soldiers died we needed more widows, because by that time the politicians had made up their minds that here was a gold mine, absolutely, which they hadn't discovered before, and instead of giving them twenty-five or thirty cents a day, it was moved up to fifty cents a day.

Then some bright boy came along and said, "That is a shame, only giving these old soldiers fifty cents a day. We will give them a dollar." Of course, that doubled the amount of pension. In order, though, to make the thing fit, dovetail in a little bit more with the progress of the country at large—because the country at large was progressing, too, just as we were, and we wanted to keep up with it—we moved it from $170,000 to $175,000, and finally up to $180,000 and $190,000, and figured, "Let the hide go with hen." It didn't make any difference. Just so she was married at all to any confederate soldier it was all right. We took down the bars and gave them all a dollar apiece.

There is another side to all this thing. It is really very fascinating. I could talk about it all night. You will have to pardon the personal allusions, because this is really a personal conversation, and you can see why I didn't want to get it into the record.

The effect of all this business is that the attraction has proved too great for human honesty. We get along to where we think, "Everybody else is getting it, so why not us? The government is doing this whole business anyway, and we will find some means whereby we can enlarge it and also widen its scope, take in more people."

We had a confederate home down in Mississippi which we started, which was a fine thing. Mind you, I am in favor of all these things. When I was in the legislature I never voted against an appropriation in my life. (Laughter and applause) It is fine, you know, if you can stand up under it. Finally we got to the point where we had this soldiers' home.

My father lived to be within twenty days of ninety years of age. He was a soldier in the confederate army for four years. He went to visit this old soldiers' home just about two years before his death. He was very much depressed. He came away and told me

that he had been there, had spent two or three hours, and he couldn't find any old confederate soldiers. (Laughter)

He said, "I couldn't find a single man in two hours who could tell me what command he belonged to or what battle he had ever fought in." He said, "I don't think we have a thing there except just an old-age home. I am in favor of maintaining it as an old-age home, but I don't think they ought to be allowed to wear a confederate uniform."

I agreed with him. That comes along with all these things and is going to happen with all of them.

So when my young friend over here, and also Professor Stauffer, began making a little fun of this $30 every Thursday plan—I don't care what day you pay it on, just so you pay it (laughter)—they are just reckoning without their host, because I hope I live long enough to see the time when we will get that $30 every Thursday. (Laughter) Certainly, that is where we are heading. You can make all the fun you want to of it now, but some day some politician will say that there is nothing wrong at all about that, only instead of making it $30 every Thursday it ought to be $30 every Monday and Thursday. (Laughter and applause)

Mr. Edmonds: Mr. President, I would like to invite Commissioner Stone to come out and make a speech in my campaign in Pennsylvania.

Mr. Long: Have you supported the $50 every Monday?

Mr. Edmonds: Not yet.

Dixwell L. Pierce (California): So many unkind things have been said about $30 every Thursday that, coming from California, I am beginning to feel a little bit sensitive.

There is an interesting commentary on what Mr. Blough said as to the tax implications of any scheme of this kind. It has been a little difficult to get the proponents of the $30 every Thursday to do any more than wax evangelical on the subject. They have rented a good deal of radio time out there—this will be very interesting in view of the allusions that Mr. Stone has just been making — and they usually open the program by playing the "Battle Hymn of the Republic." (Laughter) On occasion, they have closed it with "John Brown's Body."

In any event, they get everybody all stirred up emotionally and the speaker makes the most wonderful exhortation and asks the listeners if they wouldn't like a new suit of clothes and plenty of ham and eggs, and all that sort of thing. Of course, there are lots of people who would and don't happen to have the price right now, so, as Mr. Stone says, they are all for anything that seems to give promise of that.

The advocates of $30 every Thursday have said publicly, and they repeat in their addresses in the broadcasts, that no tax is involved, that these warrants are self-liquidating. (Laughter) That intrigued me very much, because I am somewhat like Mr. Blough in that I don't figure that fast, or maybe I don't know how to use statistics.

In any event, we finally cornered one of the proponents of the plan and got him to talk to us in Sacramento at a luncheon meeting. I say "we." We have a state employees' men's club which meets somewhat after the manner of a service club, only we go back to work at one o'clock and don't stay until two.

So we got the manager of the Sacramento office of the $30 every Thursday plan to come and tell us the advantages of it. We really felt we would like to know, because the law contemplates that we get half of our salaries in these warrants; therefore, we have a really personal interest in that.

He made the usual speech, the type we had heard over the radio. You got to the point, when listening to it on the radio, where you turned it off because it was really so perfectly idiotic that you felt annoyed with yourself for listening to it.

He made his explanation, and it was rather plausible if you didn't follow what he said too closely. When he got through, someone asked him how he got around Gresham's law. He asked what that was. (Laughter) Well, the man thought maybe he was asking in really good faith, so he explained briefly what Gresham's law was. He replied that that was long after the civil war; things had changed now. So that was the answer to that.

Then someone asked him—as a matter of fact, I did—"You say there is no tax involved. How do you account for the two cents that you must invest each week in the stamp to put on the back of the warrant? What do you call that, anyway?"

He said, "Well, that is just a contribution toward the self-liquidating factor of the warrant."

You can call it a contribution if you want to, I don't see that it is much different from the contribution you make when you pay three cents on a dollar's worth of goods you may have bought subject to sales tax. But they evidently do, or think they do.

We have made a little careful calculation to see what that plan would cost the people of California if they should be so unfortunate as to be inflicted with it. At the very minimum, that is, on the basis which these proponents say would be qualified for the pension, it would be about $800,000,000 a year.

You see, you have to do some rather unusual calculations to arrive at it. We know from the census approximately how many persons there are in the state over fifty, although they say the population in that regard has been increasing very fast lately. But you can't tell how many of them may be eligible for the benefits because they have no other employment or no other business. They could

have other income, but as long as they are not engaged in business or not employed, they would be entitled to these warrants every Thursday. So that would be about $800,000,000 a year.

Our total tax burden in California, federal, state and local, isn't that much, and I think we have the rather dubious distinction of having the second highest per capita tax of any state in the union. I think Nevada beats us, but they haven't any population to speak of; I mean, it is a very small population, as you know. So we have the second highest per capita tax already, and it is about, in round figures, $750,000,000, or it was for the last fiscal year.

They at one stroke of the pen—of course, as Mr. Stone has reminded you, they are just starting something then; they are not finishing anything—they would have us spend $800,000,000.

I see Chairman Leland looking at me, so I know it is time to stop. But the thing I wanted to point out there—and it is so appropriate in view of what Mr. Stone has said—is that these schemes do involve perfectly tremendous burdens, and it is time that those of us who are interested in taxation point that out and don't let them get too much allured by the bait.

President Leland: Is there any further discussion?

Of course, one of the things that interested me personally in the report that Mr. Blough read was that he pointed out how poorly qualified we as tax men are to decide upon the broad issues which are involved whenever the state embarks upon taxation for non-fiscal ends. But he carefully avoided even intimating who was qualified to make those decisions.

If you begin to try to answer that question, you run into the difficulties of intellectual and geographical specialization. Your political scientists are not even qualified to advise as to the form of government involved in the execution of non-fiscal measures, because they know nothing of social consequences, not to mention economic consequences.

The economists know nothing of the social gains or anything except the monetary aspects of the program. The psychologists can only tell you whether you have the thing in good form or not; and so you go around hunting for some animal who can take an all-sided view of the matter, and can correctly measure all of these ends to be attained.

I only know one man who feels that he is in that enviable position, to carefully weigh all of those various things, and yet his idea is that all that is summed up and embraced in that very elusive term, which has no definite connotation, namely, the field, or the person of the administrator.

The only persons whom I have ever run across who could really weigh all of these things are the scholars in the concept of both Plato and Aristotle. Yet these are the decisions which, while we

must avoid them, and while we are so conscious of our limitations, Mr. Blough has not been able to impress upon others; and so we are not very much ahead of where we were last night at this time.

Mr. Blough: Would you permit me to say a couple of words to that statement?

I think that is a very fair criticism of my position, but I don't think it answers the question which is raised by the position I have taken. I think we are going to have to develop some type of machinery whereby these specialists can get together, educate each other across the table and arrive at some group evaluation of measures of this type. I frankly don't think the person who has given his whole attention to fiscal problems is necessarily a good man to decide on certain programs of expenditure. I think it is quite clear that the fiscal man is almost always "agin 'em," whatever they are, good, bad or indifferent.

Likewise, the educator, for example, is really not in a position to say how much should be spent on education. To me it is one of the most serious things that we face in policy formation, and I think the answer can come only through some sort of coordination whereby we can get a number of points of view together and out of an exchange of ideas perhaps we can arrive at something like a real social policy.

I don't know whether you were in earnest or not, but I am.

President Leland: Yes, I am in earnest; I am in earnest very much.

Let me say in answer to that, that is the concept of this thing that you call a social scientist instead of either a political scientist, an anthropologist, a psychologist or what-not, and it is the theory on which at least one institution that I know of has oriented its thinking and its departmental organization mainly, and brought these groups with different disciplines into rather close quarters so that they can fertilize each other's minds and bring to bear the various elements on the problem; but even that I don't think is a complete answer to the question, because manifestly only a very few things are covered.

I didn't want to do more than point out some of the difficulties, and I am quite agreeable that Mr. Blough has made a good answer to that question.

Mr. Stone: The politician and human nature are going to give you the answer.

President Leland: You are only using "politician," though, in the sense of Plato; that is, simply the scholar who takes all these things into account, and—has anyone else anything to say?

Well, I have two things, then, that will not jeopardize his position. The first thing I want to do is to read you a letter that came

this afternoon, which would have been read last night had it come. This is from Mr. Lawson Purdy, who is one of the founders of the association. He says:

> "I am sorry not to be present at the National Tax Conference, and if given the opportunity pay a tribute to my good friends, Allen Ripley Foote, Arthur C. Pleydell and Edward L. Heydecker, who were the founders of the National Tax Association. They foresaw a good many of the griefs we now suffer and would have saved us from them.
>
> "In this country we have this comfort, that when the people tire of what they have they change it." (Applause)

The next thing I want to do is to announce that the total attendance at this conference is 710, which exceeds all records in the history of the tax association for conferences made up primarily of non-residents. There has been one conference where the total number in attendance was greater due to the attendance of a large number of local people brought to the conference for that and other purposes. There are 41 states, Puerto Rico, and three Canadian provinces represented.

The next order of business is the report of the resolutions committee.

Mr. Long!

Mr. Long: I will be right with you. I wanted to write down the three provinces, Puerto Rico and the 41 states, and I wanted to ask you if you included the District of Columbia with the states or provinces?

President Leland: It is with states.

Mr. Long: It is a great disappointment to me that we have to go from this high level of discussion, which the president couldn't resist from getting into with relation to this social problem, back to more mundane things.

The first resolution is as follows:

> "Resolved, that the conference recommend to the National Tax Association the continuance of the committee on allocation of income."

The committee on resolutions recommends its adoption.

Mr. Mattersdorf: I move its adoption, Mr. Chairman.

(The motion was duly seconded.)

President Leland: It has been moved and seconded that the report of the resolutions committee concerning the committee on allocation of income be adopted. Is there any discussion? All in favor say, "Aye."

(Ayes.)

PRESIDENT LELAND: Opposed, "No."

(None.)

PRESIDENT LELAND: It is unanimous.

MR. LONG: The second resolution—and I am hoping that as these resolutions are read the period that the president indicates at the end by the pounding of that gavel will not go on in increasing crescendo:

> "RESOLVED, that the National Tax Association recognize the need for more adequate financial statistics dealing with states and local governments, and urge the bureau of the census through its division of financial statistics of cities to make every possible effort to expand the scope and coverage of the work it is now doing in the compilation of statistics of states and statistics of cities."

The committee recommends its adoption.

MR. PIERCE: I so move.

(The motion was duly seconded.)

PRESIDENT LELAND: No discussion? All in favor say, "Aye."

(Ayes.)

PRESIDENT LELAND: Contrary, the same sign.

(None.)

PRESIDENT LELAND: The motion is unanimously carried.

MR. LONG: The next resolution is:

> "WHEREAS, the committee on allocation of income of the National Tax Association has presented a report to this conference disapproving of the growing practice of legislatures in the several states of granting permission to jurisdictions smaller than states to levy taxes based on gross income, gross receipts, or net income; and
>
> "WHEREAS, it appears to this conference that any growth of this practice will result in the defeat of any attempt at uniformity in allocating income and in this respect make worse an already bad situation; now, therefore, be it
>
> "RESOLVED, that it is the sense of this conference that no governmental unit exercising the power to tax within a smaller governmental unit than the state (excluding from the scope hereof the District of Columbia) be authorized to impose taxes on, or measured by, gross receipts, gross income, or net income."

The committee recommends its adoption.

MR. MATTERSDORF: I so move.

(The motion was duly seconded.)

PRESIDENT LELAND: All in favor say, "Aye."

(Ayes.)

PRESIDENT LELAND: Contrary, say "No."

(None.)

PRESIDENT LELAND: The ayes have it; the motion is carried.

MR. LONG: The final resolution is:

> "RESOLVED, that the thirty-first annual conference on taxation take this method of expressing its high appreciation to those in charge of the arrangements for the accommodation and entertainment of its delegates and guests and for the most generous provisions made for their comfort and pleasure which have rendered their visit to Detroit most enjoyable and profitable; and it particularly desires to record in its minutes recognition of those individual members whose valued and signal contributions have marked the proceedings of this conference with a degree of distinction and influence."

The committee recommends its adoption.

MR. MATTERSDORF: I so move.

(The motion was duly seconded.)

PRESIDENT LELAND: All in favor say, "Aye."

(Ayes.)

PRESIDENT LELAND: Contrary, the same sign.

(None.)

PRESIDENT LELAND: The ayes have it. It is unanimous.

MR. LONG: I now would like to offer another one, which is very close to my heart, and one which I think is an expression of the vast number of people who have been in this conference, namely, the 710; that this conference go on record—all of us—expressing what is in the hearts of all those who attended, our very deep appreciation of the very splendid work which ultimately resulted in a conference which probably never has been equalled in the annals of this association, which was made possible only by almost superhuman work on the part of President Leland and through activities of his which brought to the program probably the best contributions that the association has ever had.

I am therefore going to suggest that we voice, not only for those who are gathered here but for all who were in attendance, our deep, keen appreciation of what President Leland has done. I put that in the form of a motion.

Mr. Mattersdorf: I second that motion.

Mr. Long: In order that Mr. Leland may not be embarrassed, I am going to say, all those in favor say, "Aye."

(Ayes.)

Mr. Long: All opposed, "No."

(None.)

Mr. Long: It is a unanimous vote and it is so declared.

(Mr. Long struck the table a hard blow with the gavel. Applause.)

President Leland: You are much too kind.

We have now come to the point on our order of business where it is the place to receive invitations for the next conference. Is there anyone who, after attending here, would like to invite the conference to his town?

Mr. Pierce!

Mr. Pierce: Well, as you say, it is a large order after the very splendid entertainment we have had here in Detroit, but on behalf of the state of California, and particularly on behalf of the city of San Francisco, where the international exposition will be held next year, I want to extend a very cordial invitation to the National Tax Association to hold its next annual conference there.

I believe there are on file with the secretary of the association communications from the governor of the state, the mayor of the city, the president of the exposition, the chairman of the state board of equalization, and civic organizations generally urging acceptance.

All I can say is that I hope when you come we won't give you any rainbow dollars.

President Leland: It is customary for the president to accept all invitations and for the executive committee to decide whether they want to take the conference to those places.

Do we hear any other invitations? Mr. Secretary, are there any other matters to come before the association?

Secretary Query: There have been several groups who have extended invitations, but most of those gentlemen have gone home.

We have invitations, in addition to the one from San Francisco, from Denver and Colorado Springs, from New Orleans, Des Moines, Omaha, St. Louis, St. Paul, Milwaukee, Minneapolis, Kansas City, Memphis and Nashville, Cleveland and Columbus, Chicago, Fort Worth, Houston and Dallas, Washington, D. C., and a very pressing invitation for a New York visit in 1940.

We do not lack for places to go, and all these invitations will be placed before the executive committee at the proper time.

President Leland: Is there any other business to come before the conference?

Mr. Secretary, do you have any other business you would like to mention?

There being no business, nothing further to do, this conference will expire.

(The conference adjourned *sine die* at ten-ten o'clock.)

ATTENDANCE AT THIRTY-FIRST ANNUAL CONFERENCE

ALABAMA

Curry, John C.	Alabama Tax Commission	Montgomery
Curry, Mrs. John C.	402 South Hull St.	Montgomery
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Long, Henry S.	Chairman, State Tax Commission	Montgomery
Stephens, J.A.	Chief Clerk, Income Tax Dept., State Tax Commission	Montgomery

ARIZONA

O'Neil, D. C.	Chairman, Arizona State Tax Commission	Phoenix
O'Neil, Mrs. D. C.		Phoenix

ARKANSAS

Ashbaugh, E. E.	Secretary, Ark. Corp. Comm.	Little Rock
Day, Leon	Ark. Revenue Dept.	Little Rock
Nickerson, W. A.	Tax Agt., C. R. I. & P. Ry. Co., 1022 Pyramid Bldg.	Little Rock
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Pitman, Hayden W.		San Jose
Plehn, Prof. Carl C.	University of California	Berkeley
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COLORADO

Crews, F. H.	Treasurer, Crews-Beggs D. G. Co.	Pueblo
Crews, Mrs. F. H.		Pueblo
Daniels, J. Walt	County Assessor	Ft. Morgan
Lee, Clem S.	Tax Agt., Great West. Sugar Co.	Denver
McInroy, James P.	Mbr., Colorado Tax Commission	Denver
Ryan, J. J.	Tax Agt., Public Service Co. of Colorado	Denver
Seaman, John R.	Chairman, Colorado Tax Comm.	Denver
Wilson, Frank E.	Mgr. Revenue, City and County	Denver
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Holcombe, Mrs. J. L.		Wilmington

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Rightor, Chester E.	Bureau of Census	Washington
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FLORIDA

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Freeman, Mrs. Gilbert		Tallahassee
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Owens, Jas. M., Jr.	State and County Tax Assessor, 645 N. Lake Trail	Palm Beach
Wilcox, C. A.	State and County Assessor, 210 W. Turner St.	Clearwater

GEORGIA

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Boykin, William A., Jr.	Asst. Counsel, Coca-Cola Co.	Atlanta
Gillespie, S. O.	Dir., Ga. Income Tax Unit, Dept. of Rev., State Capitol	Atlanta
Sutherland, William A.	Atty., First Nat'l Bk. Bldg.	Atlanta

ILLINOIS

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Ford, J. R.	Alton & Southern R. R.	E. St. Louis
Ford, Mrs. J. R.	1510 N. 45th St.	E. St. Louis
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Garvey, Mrs. J. J.	1811 W. 88th St.	Chicago
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Green, Mrs. H. F.	340 W. Harrison St.	Chicago
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Hessler, W. G.	U. S. Gypsum Co., 300 W. Adams St.	Chicago
Hoffman, Robert B.	Pacific Fruit Express Co., 58 E. Washington St.	Chicago
Holt, Robert N.	Attorney, 110 S. Dearborn St.	Chicago
Hulson, Herbert T.	County Treasurer	Macomb

Hunter, M. H.	Head, Dept. of Economics, Univ. of Ill., 225 Commerce Bldg.	Urbana
Hunter, Mrs. M. H.		Urbana
Huntington, Frank B.	General Auditor, B. & O. C. T. R. R., Grand Central Station	Chicago
Huston, J. W.	Supervisor, Legal & Research Div., Ill. Dept. of Finance, 168 N. Illinois St.	Springfield
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NOTE: The Index does not contain the names of the participants nor papers delivered during the round table conferences held during the Thirty-first Annual Conference. However, the names of participants and discussion during each round table, as reported by each recording secretary, are carried in the proceedings of each round table.—THE SECRETARY.